WALL STREET ACCOUNTING

A DESCRIPTION OF THE BUSINESS OF BROKERAGE, ITS ACCOUNTING RECORDS AND PROCEDURE

By

FREDERICK S. TODMAN, M.C.S., C.P.A.

NEW YORK
THE RONALD PRESS COMPANY
1921

To the

Late Charles Waldo Haskins

and

The School of Commerce, Accounts and Finance

of New York University

of which he was the first dean

this book is dedicated

PREFACE

The present volume represents an enlargement and fundamental revision of the author's "Brokerage Accounts," published in 1916.

The functions of the great Exchanges have not been altered by the march of the extraordinary events of the last five years. Their economic value has become more fully and more widely recognized during and since the World War. Their accounting procedure, however, has had to be very largely reconstituted to take care of the grave responsibilities and the overwhelming volume of business of these years.

In pre-war years the annual average of bond sales totaled $800,000,000. Today the volume of bond sales reaches very near to $6,800,000,000. In 1920 the sales of stocks approximated 224,000,000 shares as against an annual average of 196,500,000 before the war. To develop adequately the old system of accounting so that the enormous turnover of business could be handled without a physical breakdown of the recording machinery necessitated the closest and most intensive accounting study. The resulting elaboration and modification in Wall Street accounting procedure has made desirable a thorough revision and modernization of the old volume.

It is the author's hope that this effort at a systematic presentation of a complex subject may prove useful to his brother accountants, as well as to the brokerage fraternity daily confronted with these technical accounting problems.

Acknowledgment is expressed to the following gentlemen for their kind and generous assistance: Charles R. Taylor,

B.C.S., Instructor at the College of the City of New York; Arthur Longendyke of the Secretary's office, New York Stock Exchange; and J. A. S. Dunn, Treasurer of the New York Coffee and Sugar Clearing Association.

F. S. Todman

New York City,
August 15, 1921.

CONTENTS

Part I—Stock Brokerage

Part II—Cotton Brokerage

Part III—Produce Brokerage

Appendix

FORMS

Stock Brokerage

Cotton Brokerage

Produce Brokerage

Wall Street Accounting

PART I

STOCK BROKERAGE

CHAPTER I

THE BROKERAGE BUSINESS

Historical Review

The term "broker" is used in a general sense to designate a person who acts as an intermediary in effecting an exchange of economic goods or services. More specifically, however, the expression, when employed in connection with Wall Street, is confined to any individual or concern engaged in the business of purchasing and selling securities or commodities for "spot" or future delivery. For the services so rendered the broker charges a commission.

It is interesting and instructive to trace briefly the origin of the brokerage business, the practices and accounting methods of which are about to be discussed. Tracing the growth of brokers and Exchanges historically, as far back as the fifth century, B. C., Proxe Netae and Collegia Mercatoria existed in Rome. The first term applied to the broker; the second, to the institution of which he was a member and which was comparable in form to a modern Stock Exchange. The activities of the Roman broker comprised not alone brokerage, but banking and exchanging as well, and he was regarded as a public officer. The broker of today follows closely in the path of his predecessor, as the larger brokerage houses maintain banking departments and a depository for securities lodged with them for safe-keeping or for sale.

Formation of Stock Exchanges

In the seventeenth century, about the time of the establishment of the Bank of England, the London Stock Exchange was founded by a board of brokers. This action was prompted

by the necessity of regulating acute competition among unorganized traders in securities. In order to put an end to this competition recourse was had to the rules and organization of an Exchange. In this country the founding of the first Stock Exchange with fixed rules of government was conceived by a body of dealers in securities in Philadelphia, who established the Stock Exchange in that city in the early part of the eighteenth century. In 1817 the New York Stock Exchange was established on the lines of its Philadelphia predecessor. The highest standard of business ethics has been the aim of these institutions since their foundation, and their rules of conduct are severe. Any infraction of the rules results in either the suspension or expulsion of the offending member. This severity is well merited when one considers the great trust reposed in the broker by his clients. Not only has the Exchange sought to safeguard the public in its dealings with members, but the statutory laws of this state penalize infractions of the trust so reposed.

The Broker as a Middleman

The service rendered by the broker as a middleman became more and more extensive and important with the creation of the financial machinery by which industry, commerce, and agriculture are promoted. The form of business known as the "corporation" came into being in the seventeenth century, when the first great banking, trading, and colonizing companies were formed. The introduction of railroads in the third decade of the nineteenth century also greatly stimulated the corporate form of business, as these new undertakings required larger investments of capital than could be furnished by any individual or firm. In the expansion of business which followed the harnessing of steam to industry, the corporate form of organization became more generally used for all kinds of business enterprises. The consequent issuance of shares by corpor-

ations offered a standing invitation to make profitable use of idle capital. Upon the broker devolved the middleman's task of bringing about the union of idle capital and the enterprising business in need of it. This union was effected through the sale of corporate securities to the customers of the broker. As previously explained, his individual efforts were transferred to and regulated by the Stock Exchange, where today the merits of corporate issues are first decided upon before their sale is permitted to the public through the medium of the security market.

Speculation in Securities

With the advent of the corporation and the public sale of its securities, speculation in such securities naturally followed. Customers were needed for banking, railroad, and industrial shares, and every new enterprise furnished additional material for speculative ventures. The necessity of maintaining a regular and steady market for shares of stock of all kinds really prompted the establishment of the modern Exchange. Today, New York's market quotes the prices of securities from almost every part of the world, and day by day it adds to its list securities which before the war were dealt in only on the London Stock Exchange. At present, this gigantic Wall Street bourse lists bond issues totaling more than $18,000,000,000, stocks having a par value of $17,000,000,000, and over 13,000,000 shares of stock having no par value—an aggregate of wealth approximating at its market valuation a sum of over $40,000,000,000.

Wall Street, in its broader sense, includes not only the Stock Exchange and the banks, but embraces also the Cotton Exchange, which affords a market for the disposal of America's annual cotton crop; the Produce Exchange, which deals mainly in cottonseed-oil; and the coffee and sugar markets. As these latter institutions are second in importance only to the Stock

Exchange itself, their methods must also be discussed in any comprehensive consideration of Wall Street accounting. The subject matter in the text will follow the order of importance allotted to the respective Exchanges.

To summarize, it may be said that the evolution of our modern Exchanges has been brought about by the growth of a natural economic need. The function the Exchanges perform is to give mobility to capital, a duty which is as important as creating wealth itself. The American Exchange system is based on sound fundamental principles which justify its existence as part of the financial mechanism required to carry on the daily routine of civilization.

Representation on the Exchange

All the more important concerns engaged in the trading of securities for the benefit of third parties have representation on the "Board" or "floor" of the Stock Exchange in the person of a firm member. All orders for the purchase or sale of securities are sent to him for execution.

Many concerns, however, though actively engaged in the stock and bond business, have no connection with the Stock Exchange. Their orders are given to a brokerage firm with membership on the Exchange, and the latter firm treats the transactions the same as other customers' commitments.

There is still another group of Stock Exchange concerns which, while operating on the Exchange, do not settle their own transactions, leaving this matter entirely in the hands of other firms. For this service they are charged a special commission ranging between 1¾ and 5 cents per share on purchases or sales.

Equipment of Broker's Office

The broker, like every other business man, depends upon his customers for his livelihood. He must therefore provide

a place where his clients can watch the fluctuations of the market in which they may be interested. To this end a separate office, known as a "customers' room," is devoted to their use. The room is equipped with electric news tickers and stock-quotation machines, as means of providing up-to-the-minute information to those engaged in stock-market operations. Another office peculiar to the brokerage business is the so-called "wire-room," from which private telephones lead to the various Exchanges, and which is thus the center for receiving orders for the purchase and sale of securities and commodities.

Relationship of Customer and Broker

The transactions of the broker may be either for his own account or for the account of others, or with others jointly. The most important and numerous transactions are for the account of others, covering obligations the broker contracts in trading for their benefit. In such transactions he acts first as an agent who buys or sells for those customers from whom he receives orders. His second position is that of a creditor; he is called upon to advance sums of money in order that a contract into which he has entered for others may be completed, and to the extent of such advances he becomes a creditor to the person on whose account funds are disbursed. Invariably, whenever an advance is made, it entails the receipt of collateral securities which the broker holds as pledgee against such advances. Sometimes these transactions involve the safe-keeping of securities, in which case the broker becomes a trustee. In that capacity, he owes to his beneficiary the proper discharge of the duties created through the establishment of the trust.

The relationship of the broker towards his customer determines the method of account keeping, since the question of the legal position of agency transactions arises in connection with this relationship. Under the law, it is the duty of the agent to keep separate and distinct from his own affairs the

accounts relating to his customers' transactions. There must be a clear understanding between the broker and his customer of the legal obligations of both parties.

Duties of the Broker

Briefly enumerated, the legal responsibilities and duties of broker and customer are as follows:

1. The law of agency imposes upon the broker the exercise of reasonable skill, diligence, and good faith.

2. The broker contracts, although only impliedly, to provide the means with which to make delivery to the purchaser in the event of a short sale by a customer.

3. The broker also agrees to carry the short account of a customer for a reasonable length of time, thus allowing the latter an opportunity to buy in or "cover" such shortage at a lower or higher price than his short sale.

4. The duty devolves upon the broker to notify his principal of his intention to close the latter's account unless the margin is sufficiently increased to protect the customer's holdings. The circumstances of each case determine the propriety of closing an account, and involve questions of reasonable time, adequate notice, past habit of dealing, custom, and other factors which preclude the establishment of fixed rules to govern the broker's action.

5. Inasmuch as the broker is an agent, he must render an accounting to the customer whenever such a statement is demanded. An action may be instituted against the broker upon his failure to comply with the customer's demand for a statement. Here, again, the fiduciary nature of the broker's employment is manifest.

Duties of the Customer

The customer, as well as the broker, has duties to perform and rules to observe in his transactions, as follows:

1. The customer should keep his account amply "margined."

2. The customer must indemnify the broker for all outlays and losses incurred for the former's account.

3. The customer impliedly agrees to pay the usual commission, and as soon as his order is filled, this charge automatically becomes an obligation.

4. The customer impliedly authorizes the broker to pledge any securities purchased for his (the customer's) account for an amount not to exceed the total indebtedness in such account. Formerly this authority was frequently carried so far as to jeopardize the customer's equity. To prevent this malpractice, a law has been enacted which strictly forbids the broker from overborrowing on his principal's securities unless a written waiver of the law is first obtained. Violation of this law makes the offender liable for an action in conversion.

Rules of the Stock Exchange

Both the customer and the broker agree to abide by the rules and regulations of the Exchange where the transaction is consummated. The constitution of the New York Stock Exchange is so hedged about with rules governing trading and the conduct of its members that misunderstandings as to the proper procedure in dealing in securities are seldom referred to court for decision.

Duration of the Agency Relationship

The rights and duties of the two parties, broker and customer, continue until the purposes of the agency relationship have been consummated. They are terminated by the sale of the securities held by the broker for the benefit of his principal; or by a transfer of the account and the securities it contains upon payment by the customer; or upon payment for his benefit by a third party.

In cases where a customer is "short" of the market, the account is technically closed at the time of "cover," that is, when a purchase is made against the previous sale.

In marginal transactions it must be remembered that the broker advances the major portion of the money necessary to finance the customer's operations. Because of these advances, he retains an interest in the contract which makes the agency relationship irrevocable until such time as the full indebtedness shall have been paid.

CHAPTER II

THE BOOKS OF ACCOUNT

The Accounting Department

The most important department of work in the broker's office is the accounting division, which in a large organization is divided into:

1. Comparison and clearing house department
2. Blotter department
3. Cashier's department
4. Bookkeeper's department
5. Margin department

To the comparison and clearing house department falls the duty of confirming the contracts entered into by brokers on behalf of clients or for themselves. The blotter clerks prepare data relating to the transactions entered into, for use by the cashiers, who in turn attend to the necessary deliveries, receipts, and payments incidental to the purchase and sale of securities. The bookkeepers record values and keep other technical records to be discussed later. The margin department attends to the adjustment of market quotations and to the transactions of customers engaged in marginal trading, which involves the keeping of records showing the changes in the financial status of accounts caused by price fluctuations.

Influence of State Law and Exchange Rules on Records

Individual needs in the business of brokerage require that the set of books employed to record the transactions be of such construction, ruling, and arrangement as to conform not only to the type of the organization, but to the somewhat dictatorial

nature of bookkeeping custom which prevails in the "Street." The technical character of the business itself presupposes a set of rather technical books. Also, to some extent, the books are affected by federal laws and by those of New York State as well as by rules of the Exchange. Likewise, the by-laws of the Stock Exchange relating to the delivery of securities and to commissions prescribe certain books which must contain special information. To illustrate the extent of Exchange supervision, the Board of Governors, or any special committee which that body may designate, may demand and enforce the production of all the private books of account used by any member of the Exchange, under pain of suspension or expulsion.

Uniformity in Brokerage Bookkeeping

Unlike the books of mercantile or manufacturing businesses, which are so often the unrestricted selection of the employer or the bookkeeper and vary in almost every case, brokerage books are, to a large extent, uniform in all brokerage houses. What is more, the uniformity persists in spite of the fact that a better grasp of accounting principles may dictate, in some instances, a more sensible and accurate handling of certain items. Even though the books may be elaborated and may vary as to detail, the principles underlying the theory and the construction of the accounts remain unchanged and unchallenged.

Behind this supporting theory is to be found the inviolable custom of doing business. Each brokerage house meets practically the same problems as does its neighbor, and the solution and disposition of the problems are universally well established. There are seldom to be met two conflicting theories to render a problem unworkable.

For purposes of analogy, let us take two banks doing the same kind of business and located in the same vicinity. As the supreme authority, the banking laws are the directive agencies

for the conduct of the business. A strict adherence to banking custom, or what may be termed precedent, would very likely be responsible for the establishment of some positive accounting system which would be found in either bank. The introduction of the clearing house brings new needs in connection with the records employed, which are the same for both. As a result of this we find that the system of accounts obtaining in one bank may be safely expected in the other bank doing a similar business. Thus it happens that the books of account of a business like banking or brokerage, although highly developed and diversified in character, are creatures of the same necessities, and are therefore in their important features practically the same.

At this point, the fundamental principle must be recalled that books of account are either journals or ledgers; they either recite facts or summarize them. If we can take the component parts of the antiquated day-book and call one section the purchase journal, one the sales journal, the third purchase returns, and the fourth sales returns, etc., the division should not be confusing, provided the origin and character of the books are remembered. For the same reason the high-sounding and technical names by which the records of the broker are known should not be confusing. Some of the records are statistical in nature and construction and can scarcely be called financial books of account. Others, of which mention is made later, indicate, if by no other means than their names, the class to which they belong.

Records in Use

The books of account and record most generally used in the business of buying and selling securities for customers are as follows:

1. Order book
2. Purchase and sales book

3. Blotter
4. Supplementary or general journal
5. Customers ledger
6. General ledger
7. Private ledger
8. Private journal
9. Stock ledger or securities record
10. Stocks borrowed and loaned book
11. Money borrowed and loaned book
12. Margin book
13. Stock transfer register
14. Vault lists or box book
15. Revenue tax registers (required by law)

These books and records, in the order given above, are analyzed and explained in detail in the several succeeding chapters.

CHAPTER III

METHODS OF RECORDING ORDERS

Kinds of Deliveries

Orders for the purchase and sale of securities may be any one of the following:

1. "Cash," i.e., for delivery upon the day of contract.
2. "Regular way," i.e., for delivery upon the business day following the day of contract. Saturday is not considered as a delivery day.
3. "At three days," i.e., for delivery upon the third day following the day of contract.
4. "Buyer's or seller's option" for not less than four days nor more than sixty days from day of contract.

The New York Stock Exchange rules require that:

> All contracts falling due on holidays or half-holidays shall be settled on the preceding business day, except when two or more consecutive days are holidays or half-holidays. Contracts falling due on the first of such days shall be settled on the next business day.
>
> On transactions for more than three days written contracts shall be exchanged on the day following the transaction and shall carry interest at the legal rate, unless otherwise agreed; on such contracts one day's notice shall be given, at or before 2:15 P.M., before the securities shall be delivered prior to the maturity of the contract.

Kinds of Orders

Orders may be presented by clients in different ways, e.g.:

1. A customer may order a purchase or sale of securities to be executed at the market. This means that the broker is to

fill the order immediately regardless of the price he is compelled to pay, or the price he is able to obtain, it being intended by the customer that the purchase or sale be completed at the best possible offer.

2. The order may be entered at a specified or limited price. This means that the broker is compelled to follow the instructions of his client and, if the transaction is a sale, obtain for him the price the customer has specified, or a better price if conditions permit at that particular moment. In the event of a purchase, the broker may pay only the price indicated in the order, and if he is able to buy more cheaply, the customer receives the benefit of the better price.

3. Another form of order placed by the customer is known as the "stop-loss" order. This has reference to the policy pursued by some speculators of limiting their possible losses. After the purchase of certain shares, the tendency of the market may turn downward. To prevent a total loss of margin the customer gives his broker a stop-loss order to sell at a price which is invariably lower than the current market price. Such an order is not fulfilled until this lower price is reached, in which case its immediate execution becomes necessary.

When a customer is on the short side of the market he may wish to limit his loss. This he can do by entering a stop-loss order with his broker. Such an order is always entered above the current market price. If the security later sells at that higher price, the stop-loss order is immediately executed. All stop-loss orders are good until executed or countermanded, or their character otherwise changed by instructions from the broker's client. As an illustration, assume that John Doe is short of 100 steel at 85, and that he desires to limit his loss to $500, not considering the commissions and tax charges. He enters an order to buy at 90 stop. This means that the broker cannot execute the order until the stock sells at 90 or above, when the broker must buy the shares at the market price.

The New York Stock Exchange has ruled that a stop-loss order to buy stock becomes a market order when the stock sells at or above the stop price; that a stop-loss order to sell stock becomes a market order, or one to be executed at the market, when the stock sells at or below the stop price.

Orders may be entered with a broker to become operative on the occurrence of a certain event, or they may be entered for specific periods, such as a day, a week, or a month. It is understood that unless specifically stated, all orders with the exception of stop-loss orders are regarded good only for the day upon which they are entered, and they automatically expire at the close of business on that day.

Accounting for Orders

For accounting purposes, the clerk in charge of the order book keeps a record of the date upon which the order is received; the time it is entered; the name of the customer and the duration of the order; the number of shares to be bought or sold; the name of the securities; the price at which they are to be bought or sold; the date of cancellation, if the order is canceled before its execution, or in the event of execution, the price at which the purchase or sale is made.

The entries in the order book are taken from the original order slips filed with the order department. In this department an arrangement of telephones facilitates the giving of orders to and receiving reports of executions from the Stock Exchange. Thus the office of an important brokerage house is usually equipped with private telephones over which the bond orders are transmitted, others for the transmission of orders in active securities, and still others for the transmission of orders in "odd lots." Where the volume of the transactions makes classification a convenience, books are used to record orders for (1) securities in denominations of 100 shares or multiples thereof, (2) bonds, and (3) odd lots.

CHAPTER IV

PURCHASES AND SALES RECORDS

Recording Transactions

Executed orders are permanently recorded either on loose-leaf sheets or in a bound book, whichever method answers best the purposes of the business. If the loose-leaf system is followed, a copy of the original order may be inserted in the purchases and sales book by an assistant in the order room. This would obviate a repetition of entry, which otherwise is necessary when reports of executed orders are sent by the order clerk to the accounting department for entry in the purchases and sales book.

To continue the discussion of the advantages of loose-leaf devices over the bound-book system for entry purposes, it may be remarked that the adoption of the loose-leaf system enables triplicate records to be made out through the use of carbon sheets. This triplicating process aids in facilitating the work of the office by enabling the more important departments to obtain immediately the reports of purchases and sales, without having to wait for this important information until the purchases and sales record is available, as is otherwise the case. The primary purpose of the adoption of the loose-leaf system is the ease with which the margin department and the accounting department can obtain the information required for their benefit at various times during the day. The ideal loose-leaf report sheet is about 12 inches long by 10 inches wide and contains approximately 20 items. The set of sheets in use can be distributed at any time to the margin and accounting departments, one copy being retained by the order clerk for his files.

The bound book, which has been supplanted by the loose-

leaf system, is cumbersome, since the information it contains cannot be used by more than one person at a time. In the brokerage business, where dispatch is so necessary for success, departments must not be made to wait upon the convenience of the old-fashioned recording clerk in charge of the antiquated purchases and sales book.

The orderly arrangement of entries in the purchases and sales book calls for the date of purchase or sale; the broker from whom the securities have been purchased or to whom the securities have been sold; the number of shares involved; a description of the securities; the price of the transaction; the time of the day on which the order has been executed; and the name of the customer who ordered the purchase or sale. Form 1 shows one kind of purchases and sales book.

For accounting purposes, transactions are classified into two divisions: (1) those in clearing house issues of 100 shares or multiples thereof, and (2) those in ex-clearing house issues, odd lots of both kinds of issues, and bonds. It is found very convenient to employ a purchases and sales record for each class. The ease with which odd lots of stocks and bonds can be segregated from the clearing house listings makes this division a very simple and expedient one. Thus the ex-clearing house record will contain odd lots of a clearing house and an ex-clearing house nature, hundred-share items of an ex-clearing house character, and bonds of all descriptions. The clearing house record is restricted to listings of the clearing house in lots of 100 shares or multiples thereof. The two records are similar in construction, the arrangement being such that a complete history of each transaction is given. The transactions of each day are grouped conveniently and chronologically.

Completing Purchases and Sales Records

Between the hours of 10 A.M. and 3 P.M. the accounting department, or, more accurately, the purchases and sales clerk,

PURCHASES March 1, 1920							SALES March 1, 1920						
OF WHOM PURCHASED	Nº OF SHARES	DESCRIPTION	PRICE	TIME	FOR WHOSE ACCOUNT	WHEN REC'D	TO WHOM SOLD	Nº OF SHARES	DESCRIPTION	PRICE	TIME	FOR WHOSE ACCOUNT	WHEN DEL'D
J. Moore & Co	100	Anaconda	$67\frac{1}{4}$	'R'	J. Jones	CH 3/2/20	E. F. Horton & Co	100	A R	$70\frac{1}{8}$	'R'	F. Smith	CH 3/2/20
James Wallace	500	Am Ice	33	'R'	M Bond	"							

Form 1. Purchases and Sales Book

receives from the firm's broker on the New York Stock Exchange memoranda of executed orders. These memoranda, besides serving as a basis for verifying the correctness of information already recorded in the purchases and sales records, also help to complete the record by supplying the names of those brokers from whom purchases or to whom sales have been made.

According to the Laws of 1913, Chapter 595 of the Penal Law, Section 957, a broker must deliver to his customer a statement or memorandum of each purchase or sale made for the latter, containing a description of the securities purchased or sold; the name of the person, firm, or corporation from whom they have been purchased or to whom they have been sold; and the day and the hours between which the transaction has taken place. Refusal to deliver such a statement or memorandum within twenty-four hours after written demand for it is made by the customer, or the delivery of a statement or memorandum which is false in any material respect, is a misdemeanor, punishable by fine of not more than $500, or imprisonment of not more than one year, or both.

The memoranda sent to the customers as a result of their orders recite the information taken from the purchases and sales records. A journal sheet is prepared in one typewriting process along with the statement to the customer, indicating a charge or credit. It serves as a posting medium to the customers ledger. This point will be touched on at greater length in a later chapter.

CHAPTER V

THE BLOTTER

Construction of the Blotter

The old-fashioned and quite obsolete broker's blotter might be compared to the day-book used in old-time commercial book-keeping. The blotter, like the day-book, records every fact of importance and not only serves as a basis for compiling information for posting purposes, but also contains certain historical facts which are to be regarded solely as business memoranda. The modern blotter, through its columnarization, fulfils the growing need of classified data, making it unnecessary to compile financial facts as to the kind of business done, as was the practice under the old system.

The construction of the blotter depends very largely upon the system of accounting in use. Where there are no underlying or additional books of original entry the blotter may be a combined cash and general journal, and through the columnarization, cash items can be distinguished from the journal entries, affecting merely the transfer of debits and credits from one account to another. As, however, the modern tendency is away from rather than toward the concentration of all entries in a common book, all cash items or transactions involving the exchange of cash are classified in a record known as a "cash blotter," whereas transactions involving merely charges and credits, not relating to cash, are entered in a supplementary or general journal. The purposes of segregating these two classes of entries are, first, to expedite the handling of items by book-keepers, and second, to separate cash transactions from every other kind.

This division of the books should be kept in mind when

studying the system employed. As there is no hard-bound rule compelling the separation of simple journal entries from cash entries, it might be well to expound the principles underlying the operation of the blotter which contains both transfer items and cash items.

The Journalizing Feature

Another salient feature which distinguishes one system from the other requires brief explanation. Instead of the debit and credit journal columns adjoining each other, as in the two-column journal, or appearing on the same page, the debit entries affecting the accounts in the blotter are entered on the Receive page, and the credit items on the adjoining, or Deliver page. As to cash entries, the method of recording them would be confusing to the average bookkeeper, unless he understood the technicality underlying the receipt and delivery of securities. Under the general principles of the cash book, the receipt of cash is recorded on the left side and the corresponding credit is given to the account yielding the benefit. In the case of the blotter, however, the receipt of cash is shown on the Deliver page. Again, the disbursements of cash in a commercial cash book appear on the right side of the cash book, as evidencing a credit to cash and a debit to the account to which the benefit was yielded; whereas in the blotter the disbursements are shown on the Receive page. This method is an outgrowth of the idea that a purchase and the consequent charge to a customer, or a sale and credit to a customer, are always paramount to the cash receipts or disbursements which are considered only as incidental to the transactions. Such purchases and sales involve cash payments, and it is therefore presupposed that cash will be received against delivery, and paid when securities are received. On that account, the entries in the blotter are made as follows: Receive page: debit customer and credit cash; Deliver page: debit cash and credit customer.

While it requires constant watchfulness on the part of the commercial bookkeeper to post debit and credit items correctly from the ordinary cash book, and while he must keep the principle constantly before him that an item on the disbursement page is to be read "debit account and credit cash," the arrangement of the blotter is such that when an item appears on the right-hand or Deliver page it is to be interpreted at once as a credit to the account and little mental exertion is required to post the entries correctly.

Since the blotters serve as cash books, it is necessary for the cashier to adopt some means whereby the cash balances at the close of a given day can be carried forward to the succeeding day. The cash blotter is to be looked upon as a cash book complete in itself at the close of the daily business. The balance of cash, which under this arrangement is obtained by deducting the amounts on the Receive page from the amounts on the Deliver page, is carried to a fresh sheet and used as the opening entry for the ensuing business day. The balancing of the blotter is treated in greater detail in Chapters XII and XIII, where specimen blotter forms (Forms 9a, 9b, 10a, and 10b) are given.

Ruling and Arrangement of the Blotter

The blotters may be bound or loose-leaf in form. The latter form is preferable, as it affords greater facility both in posting and in dividing the work among the clerks who have charge of the blotters. By turning to the blotter forms referred to above, it will be seen that for the most part the descriptive captions of the blotter columns are identical with the headings found in the purchases and sales record. While from this it might appear that the work is duplicated, still the repetition of the items contained in the blotter is for the purpose of giving financial expression to the purchases and sales, and other items incidental to such transactions.

Alternating Blotters

Where the bound blotter system is in operation and the volume of business is large, the bookkeepers often have little opportunity to post the items daily. This is due to the fact that the blotter is balanced late in the afternoon and that immediately afterwards the blotter clerk begins to enter the purchases and sales charges and credits, for posting on the ensuing day. In the brokerage business it is especially necessary for the records to be kept up to date.

To avoid the disadvantages of the bound blotter, many concerns which still use the system have adopted the method of alternating day blotters. Under this method, the use of two clearing house and two ex-clearing house books enables the transactions of the preceding day to be conveniently posted without interrupting the work of either the cashier's department or the blotter clerk. To this end all clearing house transactions made by customers on Monday and Wednesday are entered in a blotter known as the "Tuesday and Thursday clearing house blotter." All clearing house listings which have been dealt in on Tuesday, Thursday, Friday, and Saturday are entered in the Monday, Wednesday, and Friday clearing house blotter.

All ex-clearing house items are treated in the same way, thus giving rise to the need of a Monday, Wednesday, and Friday ex-blotter, in which the purchases and sales settled on Tuesday and Thursday are entered. The ex-blotter of Tuesday and Thursday carries also all petty cash entries, which are frequently "put through" or posted on Saturday. In order, therefore, that the name of this book shall cover its contents fully, it is usually called the "Tuesday, Thursday, and Saturday ex-blotter."

Any cash receipts or disbursements other than those incidental to the purchase or sale of securities are entered in the ex-clearing house blotter used on the day on which the receipts

are obtained or the disbursements are made. The same holds true of adjustment entries, where the system of accounts does not include a separate supplementary or general journal already referred to. Thus, the Monday, Wednesday, and Friday ex-blotter might contain an odd-lot purchase made on Saturday, and under the same date there might also appear an entry recording the receipt of $500 as margin from a customer. In other words, cash disbursements and cash receipts are posted to the various accounts concerned upon the date the cash is exchanged.

Distinction Between the Blotters

The clearing house and the ex-clearing house blotters are identical as to form. They differ only in the uses to which they are put and in the method of balancing them. Thus, the ex-clearing house blotter serves to record all the issues of stocks and bonds entered in the ex-clearing house purchases and sales books, as stated in Chapter IV. The record performs the additional function of a journal in the matter of adjustment entries and of a cash book in recording the cash receipts and the disbursements of the business. Another of its functions is to control the clearing house items after they have passed through the Stock Exchange clearing house. As can be seen, the clearing house blotter serves only the purpose of entering such issues as come directly under the jurisdiction of the clearing institute, leaving the incidental cash exchanges to the ex-clearing house records. Where all cash items are grouped, as under the modern system, the ex-clearing house blotter is known as the "cash blotter."

CHAPTER VI

THE LEDGERS

Classification

The ledgers used in the stock brokerage business may be classified as (1) customers ledger, (2) private ledger, and (3) general ledger. Some brokerage houses combine them all into one general ledger. However, as this is not generally done, the form and ruling of each ledger is here considered separately.

The Customers Ledger

On the debit side of the customers ledger, which is usually a loose-leaf arrangement, the following columnar division is generally employed: date, explanation, price and amount (to be charged). In case of a purchase the commission, which ranges between $7.50 and $20 per 100 shares, is not entered as an addition to the purchase price, but is included as part of the total cost of the purchase, i. e., the amount to be charged. Thus, in the purchase of 100 shares of United States Steel common at 104, the cost will appear as $10,415 and not $10,400. In other words, the commission charge is added to the cost of the shares, and the total placed in the amount column. Besides purchases, the interest charges, computed monthly, and the record of the net longs are shown on the debit side of the customer's account. Long securities may represent securities deposited as margin against purchases or short sales, or may represent net purchases of the same securities.

The credit side of the account records the sale of stocks and bonds and the delivery of securities to a customer for the account of the customer against liquidated balances; also cash

payments made on account of margin. Net short securities of a similar class are brought down after balancing the account. By the expression "short" is meant the selling of shares not previously purchased or held, but sold with the expectation of realizing a profit through the decline in value of such shares. The subsequent purchase of shorts is known as "short covering" or "cover."

The General Ledger

The general ledger contains the usual nominal accounts, the asset and liability accounts, and a record of the proprietors' interests. It does not carry the customers and the private ledger accounts when these are contained in the other ledgers.

The bound-book form is preferable for the general ledger if a customers ledger is in operation; otherwise it is more practical to use a loose-leaf arrangement for two reasons: First, the accounts of the customers, by reason of their voluminous character, must be carried forward so often that the loose sheets afford the only practical means of keeping the respective accounts intact. Second, the loose sheets are desirable because of the frequent change in the clientele of a brokerage concern, making the insertion or the withdrawal of sheets constantly necessary.

The ruling of the general ledger sheet does not differ from the standard ledger ruling, except that the explanatory column is wider in order that transactions may be fully recorded.

Hedged Accounts

An account may be long and short at the same time. As an illustration, a customer may be long of Union Pacific and short of United States Steel. Such an account is said to be "hedged." It is a mixed account, containing items reflecting contradictions or opposite tendencies.

The term "hedged" also means a condition of an account

in which the prominent feature is the sale of a different security from the one long, or the purchase of a different security from the one short. The true purpose of such trading is to check losses from a declining market when long stock is carried or from an advance in prices when short stock is carried.

The status of some accounts which will be found spread upon the customers ledger will be quite alarming when the point is reached for preparing the balance sheet, compiling the table of equities (Form 12b, Chapter XVI), or computing monthly interest charges on the customers' accounts. Taking a hypothetical case, let it be assumed that John Wilson purchases 100 shares of Steel at 104, and that upon this purchase he deposits the sum of $1,000 as margin (equivalent to 10 points). His debit balance then is $9,415, against which he retains an equity, or margin, in his holdings. In technical parlance, this is a "long" account. The market declines, and in order to check further loss he elects to sell 100 shares of Union Pacific at 128. After deduction is made for the usual charge for commission and tax, the proceeds from the sale of Union Pacific are $12,776. By reason of this sale Wilson receives a credit, and the account at this point is hedged. Wilson's account will then have a credit balance of $3,361. This is a fictitious credit, and the status of the account is explained by the statement that such a credit exists subject either to certain short covering or the sale of longs.

Wilson has a margin on the Steel stock. If he should either deliver the Union Pacific to his broker or cover the stock, his account will again become one of like tendencies —a simple account technically known as a long account. Or, if the Steel stock should be sold, the account will assume the simple form of a short account. In the latter case Wilson will retain an equity in his short Union Pacific to the extent of the balance of $1,000 deposited as margin, less any loss or interest charges which he may suffer on his Steel stock.

This mixed-account difficulty may be overcome by setting up separate short accounts for the purpose of segregating short sales of the customers from their long purchases, which are shown by their long accounts. This practice is the correct one, although the one first described is followed in many brokerage houses, which are lax in observing correct accounting principles.

Objections to the Hedged Account

Here the fictitious and misleading results of the mixed or hedged account should be pointed out. Besides the difficulty in reading hedged accounts, another objection is the complexity encountered in the computation of interest. As an illustration of this, take the account of Wilson, instanced above. His account shows a credit balance of $3,361, with 100 shares of Union Pacific short and 100 shares of Steel long. The purchase price of the Steel may be lost sight of, as well as the sales price of the Union Pacific, particularly if the transactions are of long standing. There is no balance on which interest may be properly computed, since the account shows only a conditional credit.

The objections to mixed accounts can be summarized thus:

1. Difficulty is experienced in calculating interest on advances made against customers' long transactions, since each month the proceeds of short sales must be separated in the account from the charges occasioned by long purchases.

2. The balance in an open account resulting from mixing long contracts with incomplete short commitments is fictitious and misleading. The practice can be likened to mixing Accounts Payable with Accounts Receivable and calling the preponderating balance Accounts Receivable, or Accounts Payable, as the case may be.

3. In the preparation of the balance sheet great caution must be exercised in listing the balances of mixed accounts

since an over- or an under-statement of Accounts Receivable or Accounts Payable would always result, unless each individual account is first analyzed and the component long and short balances are separately set up.

4. Great difficulty is experienced by the average customer in reading the monthly statement showing his longs and shorts combined in one account. The statement in its simplest form is generally difficult enough to interpret without injecting into it material that renders it altogether unintelligible.

5. Bookkeepers ignorant of proper accounting principles often resort to the unhappy method of hypothetically charging to the customers' accounts at the end of each month a sum which is calculated to measure the cover value of short commitments. In doing this they in the first place violate a principle of accounting, since they charge customers with transactions unsupported by either journal entries or vouchers, and in the second place they violate a rule of agency by making such arbitrary charges in their accounts without specific instructions from their customers. Even if the charges so made are subsequently reversed, the bookkeepers have no authority to clutter the accounts with values which do not exist.

Customers Ledger and General Ledger

In accordance with ordinary accounting principles the customers ledgers are operated as subsidiary to the general ledger, and it is in the latter that the customers' controlling accounts appear. Under the blotter system of posting to customers' accounts, there is to be found in the columnarization of the blotter special columns for debits and credits to customers, by reason of purchases or sales, money received from or disbursed to them, or any other charges or credits incidental to the transactions occurring in the regular course of business. While the individual debits and credits are posted respectively to the accounts in the customers ledger, the total footings in

the blotter under those captions are posted to the controlling accounts in the general ledger.

Definition of Customers

The term "customer" as employed in Wall Street differs greatly from the usual interpretation of this word. In a financial sense the term refers to a trader—a purchaser or seller of securities for either investment or speculation. A customer's account may show a debit balance with securities long. The value of the securities at the market price should usually exceed the amount of the debit balance, and to the extent of his margin, the customer is a creditor. On the other hand, the account may show a credit balance with securities short. Here, again, the cover value of the securities should be considered in order to determine the true status of the account. Generally speaking, it is very difficult to class the customer as debtor or creditor, for he may be both in the broad sense of these terms.

The Private Ledger

It is often advisable to keep from the minor clerks who have access to the books a knowledge of the income of the concern, the capital accounts of the proprietors, and other vital business accounts. When this is desired, the private ledger is adopted. It is kept upon the same principles of accounting as the customers ledger, so that a necessary controlling account has to be maintained in the general ledger. The balances it contains, or their totals, must appear in the trial balance.

Notwithstanding the advantages of the private ledger, the accounts belonging to it are often incorporated in the general ledger.

CHAPTER VII

THE MARGIN AND SECURITIES RECORDS

Trading on Margin

Stock trading is for the most part done on margin, i.e., the customer deposits with his broker a part of the purchase cost. It will give a clearer idea of the margin system to regard the marginal deposit as an instalment on the stock, or as a payment on account of an option. The system of margins allows the trader to carry a large line of securities with a comparatively moderate cash capital, with the result that his returns are much greater, if he is successful, than they would be if he were required to pay the whole purchase price. To illustrate, if he deposits a 10-point margin ($10 per share) on a stock selling at $100, he can carry ten times as much stock on margin as he could if he had to pay the full purchase price, and his profits or losses will be correspondingly increased.

The Margin Record

The customers' stock margin record is probably the most carefully watched of all the broker's books. It should show at all times the status of the customers' accounts, whether they be long, short, or hedged. If stocks fall, it shows when and to what extent more margin must be called. Or if a customer is operating on a credit extension allowed him by the broker, it shows just how far this has gone and how nearly the customer has reached his limit. If the margin book is not closely watched, the neglect may cause the broker heavy personal loss.

The record of margins in operation may be adequately kept either by means of a loose-leaf book or by a card sys-

tem. Whether the one or the other, it should be arranged to show at a glance the name of the account; the number of shares long or short; the description of such shares; the net price, including commission; the market price of such stocks; any losses or gains, as ascertained by comparing the prevailing market price with the cost price; the margin deposit; and, either in points or percentages, the margin remaining to carry such commitments. When this arrangement is followed, it is essential that all facts be presented quickly, systematically, and logically.

Greater expedition in the handling of margins, however, can be obtained through the adoption of the equity system, illustrated in Form 2. The arrangement of this form is as follows:

"A"

Long a/c Brooklyn, N.Y.

NO. OF SHARES	DESCRIPTION	MARKET PRICE	DEBIT	CREDIT	EQUITY
100	Stude	1½			2200 –

Form 2. Margin Sheet—Equity System

The name of the customer, his position in the market, whether long or short, the number of shares, description of stock, market price, debit, credit and equity columns.

The form is self-explanatory, excepting probably the uses of the debit and credit columns. They are introduced into the form as a guide to the margin clerk concerning the amount due in the account of a customer who owes a balance to his broker against securities which are to be taken by such customers; or, in the case of a credit balance due to the customer, mention is made thereof in the credit column, as a guide to the margin clerk. This system, which also employs the loose-leaf arrangement, carries merely a record of the margin remaining after adjusting the purchase price or the sales price in a short transaction to the present market price, and necessitates the carrying on the books of only the last market price. The system is shown in the following example:

A's Account

Debited with purchase price of 100 Studebaker bought at 140..........	$14,000.00	Deposited with his broker, a margin of...........	$2,000.00
Leaving a net debit due his broker of..........	$12,000.00	Present market value of 100 Studebaker.......	$13,500.00
		Leaving an equity to the credit of A amounting to..................	$1,500.00

A's Account (Second Assumption)

Debited with purchase price of 100 Studebaker bought at 140	$14,000.00	Deposited with his broker, a margin of...........	$2,000.00
Leaving a net debit due his broker of..........	$12,000.00	Present market value of 100 Studebaker.......	$14,200.00
		Leaving an equity to the credit of A amounting to..................	$2,200.00

According to this illustration, A has $2,000 as margin and has purchased 100 shares of Studebaker at 140. The margin

clerk subsequently, as the market changes, substitutes for the purchase price the prevailing market price, which becomes the basis for other adjustments. Assume that the last market price is 135. Thus the margin record will appear as follows: long, 100 Studebaker at 135 (market price), margin $1,500. If in the course of time the price rises to 142, the price is adjusted to 142 and the margin is changed to $2,200. (Commission and tax charges have been omitted to simplify the illustration.) This system is adopted by the larger brokerage houses, where, with the least amount of detail, the best results are obtained.

The loose-leaf margin record, rather than the card system, is the more practical and convenient in handling. The card system carries with it the usual liability of the destruction or misplacement of the cards when most needed. It is to be understood that the sheets should be arranged in alphabetical sequence, to expedite the location of accounts.

The usual marginal requirements are 10 points on the number of shares held. Frequently a percentage of the cost value will be required, but this depends altogether upon the policy of the broker or the nature of the stock carried, whether highly speculative or otherwise. In the case of a hedged account the requirements may be less.

Operations on Margin

All accounts, including those of the operator, speculator, or small trader, must be carefully watched in order to know when the calling point for additional margin is reached, or to ascertain the standing of the account after added lines have been taken on. In other words, it must be determined if the account is well enough margined to warrant an increased interest in the market, either long or short.

To illustrate, let it be assumed that a customer purchases 100 shares of Steel common at 104, depositing the usual 10 points, or $1,000. His margin sheet would reflect this pur-

chase. If the market price of Steel remains unchanged, the customer retains his equity of $1,000, less commission and tax on the transaction. Assuming, however, that the price of Steel declines to 99, the account, or condition of margin, will show an equity of approximately $500, or 5 points, since the loss in the value of the stock has consumed the other portion of the margin deposited. On the other hand, if the value of the Steel stock rises 5 points to 109, the equity or margin is increased from the original $1,000 to approximately $1,500, or from 10 to about 15 points.

The broker must keep a constant watch on the margin records. When a severe decline occurs, customers must be asked for additional margin, in order that the condition of their accounts may be improved and the margin on their securities be brought up to the proper percentage of the market prices. The vital importance of this matter is further shown in Chapter XVI in connection with the treatment of equity tables.

Selling at a price which will prevent loss to the broker or will limit his customer's loss is called a "stop-out." If the customer overlooks a call for margin, the broker frequently sells him out, which sometimes results in a loss of the entire margin, and the customer is then said to be "sold out" or "stopped out." Such selling saves the broker if done in time; but if he delays it too long, he may suffer a financial loss himself. Thus, if the price of Steel bought on margin at 104 declines to 92 it would be beyond the exhaust point, and not only would all margin be lost, but the broker would himself incur a loss. The account would then show a deficit. Legal action for the recovery of the amount of the deficit could be begun by the broker, and his suit would succeed if he had followed all the necessary legal requirements before selling out the account. Such requirements embrace the sending of a registered letter to the customer at the address last given by him, in which the following salient features appear:

1. A demand for the specified amount of margin, to be deposited by a certain time.
2. Request to the customer to take up his account, i.e., pay the debit balance due by him against delivery of the securities in the account.
3. Request to the customer to transfer the account to another broker.
4. Failing to receive satisfaction on any of the above demands, to serve notice of sale to take place upon a certain date, at a specific hour, and at a stated place; either at public auction or on the Exchange where the contract originated, or where the securities to be disposed of have a ready and available market.

The above requirements apply only to the foreclosure of long securities. Such complete notice is not imperative in a forced covering of short commitments by the broker for the account of a customer in default of margin.

Securities Record or Ledger

The securities record or ledger, as the book is interchangeably called, differs in both use and form from the ordinary stock ledger which is employed in mercantile and corporate enterprises. This particular record is not intended as one for summary purposes, nor is it a financial book. It is used only for listing securities and to show their places of deposit, or other disposition made of them.

Many forms of this book are in use, but its one underlying purpose remains the same, despite the numerous elaborations. Its most common form is the loose-leaf arrangement, as that is best adapted to the increasing or decreasing volume of securities recorded. The security holdings are of such a diversified nature that one sheet or more is allotted to each kind.

So far as possible the sheets containing the individual list-

ings of a certain issue of securities should be arranged alphabetically. The advantages thus gained are self-evident. The longs on the left side of the ledger represent customers' holdings, stocks borrowed from brokers in the Street, and Failed to Deliver items. On the right-hand side is a record of short sales, together with a list of stocks which might be "loaned" out or which might be acting as collateral in bank loans, Failed to Receive items, securities in transfer offices, in the vault, or "in depot," i.e., held for safe-keeping only.

The Ruling of the Record

Each page of this record is divided into two sections, the left side of the page being devoted to information concerning the holdings of securities, and the right side to information concerning the outgo, or the place of deposit of securities. Both sections of the page begin with an explanation column and are followed by a columnarization which provides for as many changes as there are days in the month, so that the securities long, the securities borrowed, and the Failed to Deliver items in the aggregate equal the number of shares pledged or hypothecated, loaned out, in transfer, in the vault, sold short for customers, and the Failed to Receive items (Forms 3a and 3b).

According to another arrangement, the page of the securities ledger is divided in the center by a vertical line. At the top of the leaf is inserted the name of the security recorded. The left side of the page is further subdivided into six columns, which are headed from left to right with the descriptive captions: Date, Number of Shares, Certificate Number, By Whom Owned, For Whose Account Borrowed, and From Whom Borrowed. On the right half of this page are six columns headed: Date, Number of Shares, Certificate Number, For Whose Account Short, To Whom Loaned, and Place of Deposit.

DR. 1920 Feby W.S. Steel

	1	2	3	4	5	9	10	12	16	17	21
J. Brown	100	x	x	x	100	100	100	100	100	200	x
J. Smith	200	200	200	200	100	100	100	x	x	x	x
J. Doe	500	500	500	500	500	500	500	x	x	x	x
R. Roe	100	100	100	x	x	x	x	x	x	x	x
J. Joe	100	100	100	100	100	100	100	100	100	100	x
S. Sow.	50	50	50	50	50	x	x	x	x	x	x
M. Mow	50	50	50	50	50	50	50	50	50	50	x
	1100	1000	1000	900	900	850					
A. Luffer & Co Stocks B'd.	–	–	–	–	–	–	1700	1200	1200	600	x
N.L. Cofrey & Co. "							2050	1450	200	100	x
A. Adamson Failed to Deliver									100	x	x
									1750	1050	0

Form 3. (a) Securities Record or Ledger (debit side)

(Common) CR.

1920 Feby	1	2	3	4	5	9	10	12	16	17	21
Box –	200	200	300	300	300	300	x	x	x	x	x
Transfer Office	100	x	x	x	x	x	x	x	x	x	x
Chase Bk. Loan	500	500	500	500	400	400	x	x	x	x	x
E. F. Horton. Stock Loan	100	100	100	x	x	x	x	x	x	x	x
Failed to Receive - Jones & Co	100	100	x	x	100	100	x	x	x	x	x
Depot - Safekeeping.	100	100	100	100	100	50	50	50	50	50	x
	1100	1000	1000	900	900	850					
M. Robinson	–	–	–	–	–	–	2000	1400	1400	800	x
J. Jesup							2050	1450	300	200	x
									1750	1050	0

Form 3. (b) Securities Record or Ledger (credit side)

The securities record is one of the books supervised by the cashier's department. To a great extent it operates as a check upon all securities handled in the course of the day.

Method of Keeping Securities Record

At any given time it should be possible to balance the securities by adding the number of shares of stock or bonds represented on the left side of the sheet and comparing this total with the number entered on the right side. These footings should agree. As an illustration, if John Brown is long of 100 shares of United States Steel common, the shares will appear in the securities ledger under the date of entry. If the stock has been paid for and delivered to the customer, the record will evidence the fact; but if not delivered, the right-hand side of the sheet will reveal the present place of deposit. It will show that the stock has been loaned in the Street or is serving as collateral in some bank loan; or that it is in the transfer office of the corporation awaiting re-registration or in the vault of the broker; or that delivery has been "failed upon" by the broker from whom the stock is due. In any case, the number of shares on either side of the record should balance.

Auditing the Securities Record

An auditor in checking the record should demand positive proof that the securities represented in the various customers' accounts tally with the book under inspection. Further, he should investigate and determine beyond doubt that the stocks and bonds as reflected therein are in actual existence in one of the many places mentioned. It is his duty to determine this.

The securities ledger is a permanent record. It changes from day to day with the transactions of the customers, or with a change in the place in which the securities are deposited. For instance, if M. Robinson covers his short Steel, this change is shown by an "X" mark on the Steel sheet, so far as Robin-

son affects it. Moreover, stock which is loaned in the Street one day, may find its way into a collateral loan the very next day, stock which is loaned out may be called, or stock which is borrowed may be returned. All this shifting affects the record accordingly.

Other Forms of Securities Records

Various other forms of securities records are found in use among brokers, all, however, based on the same principle as the securities record explained above. Some brokers have adopted the simpler system of having but one explanation column to the extreme left of the page and a double date columnar arrangement running the entire width of the page, as shown in the following illustration:

	United States Steel—Common					
	March 4		March 5		March 6	
John Jones—"Long"	1500	....	300	....	....	....
Fred Smith—"Short"	....	500	....	800	....	....
Transfer Office	....	400	x	x	....	....
Box	....	100	x	x	....	....
Stocks Loaned	....	200	x	x	....	....
Chase Bank	....	200	x	x	....	....
Failed to Receive	....	200	x	x	....	....
" " Deliver	....	....	x	x	....	....
Stocks Borrowed	100	....	500	....	....	....
	1600	1600	800	800	....	....

A third form of securities record has a ledger arrangement, the record being debited with longs of customers, stocks borrowed, and Failed to Deliver securities, and credited with shorts of customers, securities in transfer, securities in the

box, stocks loaned, securities pledged with banks, and Failed to Receive securities. As securities change places, the particular place of deposit is either debited with a withdrawal or credited with a new deposit. Securities are accounted for by checking the debits against the credits.

CHAPTER VIII

THE "BORROWED AND LOANED" BOOKS

Stock Loans

As introductory to this chapter it may be well to explain that the distinction between collateral in the case of money loans and loans of stock made in the Street against the payment of money depends upon the intention of the lender or the borrower. Is it the intention of the broker receiving the stock to use it for the purpose of making delivery against his customer's short sales? Or is it his intention to lend the money and hold the stock as collateral for the loan? If the first question is answered affirmatively, then a true illustration of the stock loan is furnished. In the event of the other answer, the illustration is only one of an ordinary collateral loan. Banks are in the habit of making collateral loans. Brokers, on the other hand, frequently borrow securities in cases where they are necessary for the purposes of effecting delivery against short sales.

Lending Stocks

In the course of his transactions a broker frequently requires money to meet stock purchases, and conversely, frequently requires stock to make deliveries against short sales. These needs are usually met by "collateralling" or borrowing stock, as the case may be.

The borrowing and lending of stock is peculiar to the Street. After Exchange hours, the loan crowd assembles on the floor of the Exchange. It is composed of brokers or their clerks who have stocks to lend for next day's delivery and brokers who want to borrow in order to make delivery the following day against short sales or for other purposes.

To illustrate the loan of stock, suppose a broker purchases 1,000 shares of Steel common on margin for a customer. As the customer has deposited only a 10-point margin, or such other amount as the broker may have required—or, in the case of a credit customer, has put up nothing at all—the responsibility of financing the transaction falls mainly upon the broker. Under the rules of the Stock Exchange, the purchased stock must be delivered and paid for the next day, unless other than the regular delivery is stipulated. In the case of Steel common, which is a clearing house stock, delivery is made by the broker designated by the clearing association. If it is not a clearing house stock, delivery is made by the broker from whom it has been purchased. In either case the purchasing broker must be prepared to give his check to the delivering broker on the day of delivery or the next business day after the making of the contract, with the exception of Saturday which is not a delivery day.

If the broker has funds available, the question of paying for his stock is merely a matter of drawing his check. If funds are scarce, he has two courses open to him: (1) he can borrow the money from the bank on collateral, or (2) he can borrow the money on the Street from one in need of the shares.

It is usually more expedient to borrow money by lending stocks to the Street than it is to borrow it of a bank on a collateral loan. In the first case, full market value is received; while in the latter only from 60% to 80% of the value is obtained. Stocks are also loaned to the Street more easily and conveniently than money is borrowed from a bank.

If it is a clearing house issue that is loaned, all the lending broker does is to exchange tickets with the borrowing broker, and the transaction assumes the aspect of a sale and purchase. The clearing house merely offsets the actual purchase of Steel against the loan of Steel the purchasing broker is making.

The amount involved in the transaction approximates the cost price of the shares, so that the lender of the stock pays or receives the difference between the cost price and the clearing house price—an arbitrary figure established each night by the clearing house to settle transactions of which lending and borrowing stocks are typical.

However, if the stock that is purchased is an ex-clearing house issue the loan of it is a little more difficult to arrange, because the demand for ex-clearing house listings is usually less urgent than for clearing house listings. The purchasing broker, in the case of an ex-clearing stock, either makes arrangements to lend and deliver the shares at or before 2:15 P.M. on the following business day, or, if he cannot do this, arranges to borrow the money through the medium of a collateral loan.

The question arises as to how the broker is able to effect prompt settlement for securities he has purchased but is unable to lend pending the deposit of the securities with the bank against a collateral loan. The broker delivering does not wait for payment from the receiving broker any longer than is necessary to draw the check. Through a note arrangement with the bank with which the latter broker does business, he is able to draw against the balance thus created and pay the delivering broker immediately. This arrangement is known as a clearance loan. The broker must liquidate the loan before the day is over with funds he receives by pledging his securities with a bank or lending them to the Street.

At this point the broker has bought his stock but has deposited it as collateral for the money with which it was purchased. He may call for his stock at any time, but must, of course, pay back the money borrowed on it, with interest. On the other hand, the broker or bank which loaned the money may in turn call for its repayment, with interest, and when the loan is paid the collateral is returned. In case the money is

called, the broker on the opposite side of the transaction can usually relend his stock or pledge it as collateral in a bank loan, and thus, so far as he is concerned, leave the whole matter in status quo.

This situation usually continues until the customer orders the stock sold. Upon making the sale, the broker demands the return of the shares loaned, which he receives after paying the money he borrowed and interest. The stock so redeemed is delivered to the purchaser and the transaction is concluded as between the brokers.

Borrowing Stocks

Another transaction usually handled through the loan crowd is the short sale, which, were it not for the rules of the Stock Exchange, would be nothing more or less than a sale at the market price for future delivery. The Stock Exchange, however, requires that when a sale is made delivery of the stock shall be made not later than the following day. To meet this requirement—while still making the profit or loss resulting from the short transaction—the customer making a short sale puts up a margin to protect the broker, who makes an actual sale at the market, borrowing stock and delivering it to the purchaser the following day against payment of the purchase price. The broker continues to borrow the stock until the customer orders his short sale covered. This means that the stock borrowed on his account is to be returned. The broker then buys the stock in at the market and returns it to the party from whom it has been borrowed. If the price of the stock has declined meanwhile, the customer realizes the profit between the price at which the stock was sold and the price at which the short sale is covered, less the broker's charges and the taxes. If the price of the stock has advanced, he loses the difference between the two prices, plus the broker's charges and the taxes.

Advantages of Lending and Borrowing

To repeat, lending stocks on the Street, which is equivalent to borrowing money on collateral, is a very advantageous arrangement for the broker who wishes money, inasmuch as he then borrows to the full market value, whereas, if he pledges the securities as collateral at his bank, he receives but from 60% to 80% of their value. Furthermore, the rate of interest on money loaned on stocks on the Street is usually lower than the rate charged by banks on demand loans.

The rate of interest charged for money advanced on borrowed securities approximates the rate charged in the call money market, but is really measured by the borrowing demand for, and the loanable supply of, the particular stock in the loan crowd. Thus the broker seeking to borrow a certain stock for the purpose of making delivery against a short sale of his customer must primarily consider the necessity of procuring the shares. Hence, he is not in a position to bargain too closely as to the rate of interest, nor to object to advancing the full value in money, because he must have the stock. This is advantageous for the broker lending the stock, particularly so when the market is oversold, because he can then charge a premium on the loan of stock. Thus, at a certain time in 1920, General Motors shares developed such a large short interest in the market that those who held the floating supply were in a position to charge a premium ranging up to 1% per day to borrowers of this stock. In other words, the lenders of the stock received full market value and in addition $100 per business day for every 100 shares they loaned.

Stock Loans and Market Price

The "mark-down" (market down) and the "mark-up" (market up) are transactions which are frequently made in connection with stocks borrowed or loaned. It is the custom among brokers to keep all stock loans at the market price, that

is, the money advanced or received for stocks borrowed or loaned must be kept at the market value of the stock. For example, suppose that Jones and Company borrows from Smith and Company 100 shares of Steel at 104 and that subsequently the value of these shares declines 10 points. Jones and Company then requests Smith and Company to send the former firm a check for $1,000 and also the interest that has accrued on the loan from the time of borrowing. This transaction is called a "mark-down," and a new entry under this date is made in the stocks borrowed and loaned book of Jones and Company, thereby making a new transaction of the loan. The converse of this operation is known as a "mark-up," and takes place if the price of Steel advances, say to 119. Smith and Company then issues a mark-up, or a request for a check from Jones and Company for $1,500, less interest on the principal of the loan.

Stocks Borrowed and Loaned Book

The stocks borrowed and loaned book is an underlying record supporting the ledger accounts Stocks Borrowed and Stocks Loaned. The book is usually a bound one. It is divided into two sections, one devoted to the record of borrowing transactions (Form 4a), and the other to lending transactions (Form 4b). The column headings from left to right of the Borrowed section are as follows: Date, From Whom Borrowed, Number of Shares, Description, Price (at which borrowed, usually the market or clearing house price), and Date of Return. Then follow columns for the days of the calendar month, in which appear the interest rates from day to day on the stocks borrowed. These rates are either renewed, increased, or decreased daily, depending altogether upon the conditions of demand and supply in the loan crowd.

The Loaned section of this record is identical in arrangement with the Borrowed section, with the one exception that the second column is headed "To Whom Loaned."

Checking the Record

As a check upon the stocks borrowed and loaned book, recourse may be had to the securities record already described. The money values involved in the stocks borrowed and stocks loaned should be reconcilable with the general ledger accounts bearing the captions "Stocks Borrowed" and "Stocks Loaned."

Money Borrowed and Loaned Book

As has been shown, a broker, in addition to getting funds by lending stock, can obtain them by means of the ordinary bank loan, against the deposit of securities as collateral. Any excess funds he may have he can lend upon call, taking securities as collateral.

Borrowing money from the bank, or from any other source upon collateral security, gives rise to the need of another record. The money borrowed book (Form 5) fulfils this purpose. It shows the date of the borrowing, the amount involved in the transaction, from whom borrowed, a list of the collateral given for the loan, the rate of interest, terms of payment, whether on "call" or "time," that is, for a stated period. As such loans are usually call loans on which the rates of interest fluctuate from day to day, provision must be made for recording the rate changes.

Collateral Substitutions

The method of substitutions is illustrated (Form 5) as follows:

Assume that the brokerage house of Adams, Burns and Conant has pledged 500 shares of Steel common (market price 104), 500 shares of Anaconda Copper (market price 70), and 200 shares of Union Pacific (market price 125) to secure a loan of $100,000, and that the 500 Steel shares so pledged are sold by the customer. The brokers must deliver these 500

BORROWED

DATE 1920	FROM WHOM BORROWED	Nº OF SHARES	DESCRIPTION	PRICE	DATE RET'D	INTEREST RATES AND DAYS																														
						1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31
3/11	E. J. Horton & Co	200	Anaconda	CH 67													4																			
3/14	Harrison & Co.	500	Smelters	70	3/18/20															$3\frac{1}{4}$	$3\frac{1}{2}$	4	✓													
3/18	Daymond, B.	500	"	68																				$3\frac{3}{4}$												
3/20	Hayes, A. S.	200	Am. Beet Sugar	21																						Flat										
3/25	Hall, K.	100	New H.	67																											P $\frac{1}{16}$		P $\frac{1}{32}$			

Form 4. (a) Stocks Borrowed and Loaned Book (borrowed section)

LOANED

DATE 1920	TO WHOM LOANED	Nº OF SHARES	DESCRIPTION	PRICE	DATE OF RETURN	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31
3/12	Bliss & Benner	100	National Biscuit	Each 123													P ¼																			
3/14	J. A. Ryan & Co.	200	Am. Cotton Oil	CH 44																¼																
3/16	Wolff & Co.	300	Am. Tel. & Teleg.	CH 122	3/24/20																	2	1¾	2				3	✓							

Form 4. (b) Stocks Borrowed and Loaned Book (loaned section)

Steel to the purchasing broker, and in order to release them they substitute as collateral other securities of an equal value. The lender is usually willing to accept stock of approximately the same value and rating in place of the securities which the

ADAMS, BURNS AND CONANT

Chase Natl Bank LOAN NO. 65

March 21 - 1920 $ 100,000# @ 4½% DUE Call

3/24/20	~~500 Steel~~		3/22 5¾%
	500 Anaconda		3/23 6¼%
	200 Union Pacific		3/27 5½%
3/24/20	600 Reading		

Form 5. Money Borrowed Book

borrower seeks to withdraw. If Adams, Burns and Conant have, say, 600 shares of Reading available, valued at about $54,000, they are able to effect a substitution by depositing the Reading in lieu of the Steel shares. In the event of a substitution, the stock withdrawn is crossed out and the date of withdrawal is also indicated. The substituted shares are entered on the sheet with the date of deposit.

When a money loan is repaid, the date of payment is written across the face of the page, thus attesting to the fact that the loan has been liquidated and the deposited securities returned.

Relation of Money Borrowed Book to Other Books

At this point reference should again be made to the securities ledger (Forms 3a and 3b) to trace the connection between that book and the money borrowed book. In discussing the securities ledger the place in which securities were deposited was emphasized. The securities appearing in the money borrowed book are therefore also traceable through this ledger. When substitutions are made, the fact is also borne out by this ledger. Taking the hypothetical case given above, the Reading shares substituted for the 500 Steel shares would probably be taken from the safe-deposit vault, and this would be shown in the securities ledger. The release of the Steel shares would also be shown in the securities ledger, while the blotter recording their sale and delivery would vouch for their final disposition.

When a broker lends money, the securities deposited with him as collateral do not find expression in the securities ledger, for, while they are in the hands of the broker as pledgee, in no way is it intended that their possession shall be recorded in the securities record. The collateral securities are the property of the pledger, subject, of course, to the rights and equities of the pledgee.

The general ledger accounts Money Borrowed and Money Loaned summarize the details found in the money borrowed and loaned book and act as a control of these underlying records.

The "Depot" Box

Among the securities in the possession of the broker are those which belong to customers and upon which the broker has no lien. The broker is compelled under the law to keep separate and distinct all stocks and bonds which are held free and clear, for the benefit of customers. Under such circumstances he becomes a depositary, and he must use reasonable

care in the matter of safeguarding the documents entrusted to him.

The status of a customer's account, as evidenced by the margin records, determines whether or not securities carried by the customer should be passed to the "depot" box, that is to say, kept apart from other shares in which the broker has an interest because of the debit balances that have arisen from the customer's purchases.

The term "in depot" is used to refer to securities that have either been paid for or deposited for safe-keeping by customers. For the purpose of recording the contents of the depot box, a sheet or folio is kept by the cashier, showing the date of deposit, the number of shares, the description of the stock, and the name of the customer to whom the shares or bonds belong. When the securities are delivered to their owner, the disposition is evidenced by crossing out the entry and writing in the date of the delivery.

Active Box

As differentiated from the securities contained in the depot box, all stocks and bonds against which there is a debit balance owing by the customer are carried in the so-called "active" box, unless pledged for the purpose of borrowing funds.

In the course of business, it is to be expected that securities will be received and delivered, and this turnover will perforce affect the list of those securities which are in the active box at the beginning of the day. All changes from day to day must be recorded, which entails a daily rewriting of the active box sheets. All stocks to be received and paid for by the broker and stocks delivered against sale are recorded by listing the changes upon the active box sheet, provided the securities coming in and going out are those received or delivered upon marginal transactions.

Daily Count of Securities

A physical count of securities is made at the end of business each day, and the check upon the accuracy of these shares and bonds is obtained by comparing the physical securities with the listed items on the active box list. All discrepancies are noted, so that proper investigation can be made immediately for the purpose of tracing any shortage or differences.

The final verification of the box records, both depot and active, is obtained through checking the box lists against the securities record or ledger.

CHAPTER IX

TAX AND STOCK TRANSFER REGISTERS

New York State Law Requirements

By the New York State law which became effective June 30, 1905, all shares of stock sold or transferred were made subject to a tax of 2 cents per share, regardless of par value. This law was subsequently amended so that the levy is now 2 cents on each $100 par value of stock transferred. For some time the transfer offices seldom requested the production of the stamps in effecting transfers, and the law was frequently evaded by using canceled stamps to cover more than one transfer. An act was therefore passed which makes it compulsory for stock-brokers to record all transfers, either through sale or re-registration. The face value of the stamps used in the transfers must also be stated. The book in which these entries are made is called the "revenue tax register" and is shown in Form 6.

The revenue tax register provides space for the date of either sale or transfer of stock, the name of the stock, the number of shares, face value (par value) of the shares, and name of purchaser or transferee. The latter calls for the name of the purchasing broker or the person to whose name the certificates are transferred.

The special columns on the right of the revenue tax register are for the statement of the number and face value of the stamps used, and are designed to prevent the double use of transfer stamps.

In the early days of the tax petty thieving of revenue stamps, made possible by the system then in use, was not uncommon, as no complete record of the stamps was kept. The

Adams, Burns and Conant
(Name of Individual or Firm issuing this record)

DATE 1920	NAME OF STOCK	Nº OF SHARES	PAR VALUE PER SH	NAME OF PURCHASER OR TRANSFEREE	Nº AND FACE VALUE OF STAMPS									VALUE
					2¢	4¢	10¢	20¢	50¢	\$1	\$2	\$10	\$20	
2/15	Union Pacific	200	\$100	E. F. Horton & Co							2			4 00
	Reading	100	50	Robt. Goodhue & Co					2					1 00
	Anaconda	30	100	J. Jones				3						60

Form 6. Revenue Tax Register (New York State)

present revenue tax register, which is required by law, has overcome this evil by providing a means for checking the inventory of such stamps. The used stamps are recorded in this register. Adding the amount used to the physical inventory gives the amount charged to the Revenue Stamps account in the general ledger at the beginning of the period. To expedite the physical count separate envelopes are used for each denomination.

Federal Law Requirements

In compliance with the Revenue Act of 1918, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, has made and promulgated certain rules and regulations for the proper enforcement of the statute. Among other things, he has prescribed a form of return brokers must use in reporting their stock transfers. (For general instructions on filling out this form see Appendix A.)

The specific requirements on the form are as follows:

Any person who makes sales, transfers, or purchases of shares of stock at, on, or in any exchange, must make a return of these transactions each month on forms to be provided by the Commissioner of Internal Revenue, whether the sales, transactions, or purchases shall be settled, carried, or cleared by himself, or otherwise. If during any month he shall have made no sale, transfer, or purchase, he shall so state on the face of the return, in the space for "Remarks."

Returns of transactions for each month must be made, verified, and mailed or delivered by hand, to the Commissioner or duly designated officer on or before the fifteenth day of the following month.

All figures reported should be checked carefully against the facts as disclosed by the books of record.

Returns must be signed and verified by a member of the firm or by an employee who has personal knowledge of the facts set forth in the return.

The writing in of the terms must be in ink to insure permanency. Returns in pencil are not accepted.

An affidavit as to the correctness of the returns must be made by the person making his own return, or by a duly authorized agent having a sufficient personal knowledge of the affairs and dealings of the person or partnership for whom the return is made to make a full and complete return of all the transactions of that person or partnership.

Under the subheading "Aggregate Face Value not Including Fractions of Less Than $100" is to be entered the aggregate face (or par) value, in the number of thousands or hundreds of dollars, in figures of not less than an even hundred or hundreds. For example, say on some particular day the following sales are made:

Shares	Face Value	Total Face Value	Tax
100	$100.00	$10,0 00.00	$2.00
125	25.00	3,1 25.00	.64
310	5.00	1,5 50.00	.32
2500	.01	25.00	.02
		14,6 (3 frac.)	$2.98

As there are 146 hundreds involved, the numerals 146 are to be entered in the column "Aggregate Face Value, etc."; and as there are three fractions of less than $100 in the aggregate face value of the sales, viz., $25, $50, and $25, in the second, third, and fourth sales respectively, the numeral three is to be entered in the column headed "Number of Fractions of Less Than $100." The tax is figured as follows: 146 hundreds at 2 cents equals $2.92, and three fractions of less than $100 at 2 cents for each fraction equals 6 cents; total, $2.98. In the tax paid column is to be entered the total amount of tax paid each day on all shares having a face value sold that day. The same instructions and examples outlined in the preceding paragraph apply to the returns of shares having no face

(or par) value under the subheadings "Aggregate Value, etc.," and "Number of Fractions, etc.," except that in these latter cases the market, or sale value is taken instead of the face value. For the tax paid column the instructions are the same as given in Section 7.

In the column devoted to the transfer of customers' accounts is entered the number of shares which had been in the possession of, or held by, a person for the account of a customer and turned over to another person on the instructions of the customer—in other words, a simple transfer or shifting of the account or securities to another person or firm without there being any change of ownership in the securities.

In cases in which a person is both buyer and seller, or in which he "matches," "crosses," or "pairs off" a purchase or sale with or against the other or makes a so-called "on order" transaction, and such transaction is included in "To Deliver" and "To Receive" or in the purchases and sales on the clearing house sheet, he must make a return of the transaction in the proper columns on the sale and purchase sides of his return and in the settlement column headed "Matched, etc."

Under the subheading "Other Than Matched or On Order, etc.," entry is made, on their respective sides, of the sales and purchases that have been "set off" through the clearing house by the sale and purchase of like quantities of the same stock, other than those in the "matched" or "on order," etc., trades.

If at any time a sale or purchase is settled by any other method than those enumerated in the return, a record of such sale or purchase must be made in the proper column or columns and the settlement entered in the column headed with an asterisk (*).

Internal Revenue Regulations

The source of the data to be placed in the return is the sales records prescribed by the Internal Revenue Department of the

United States Treasury. The department, in Regulations No. 40 relating to the stamp tax on issues, sales, transfers of stocks, and sales of products for future delivery, describes in detail how the records of sales or transfers of stock should be kept. This, in epitomized form, is as follows:

All persons who are wholly or partly engaged in the business of buying, selling, or transferring shares of stock, whether at public or private sale, or whether or not they are members of an Exchange, including persons engaged in transactions known as "matches," "on order," "pass outs," "give ups," or transactions settled directly between the seller and the buyer, or cleared or adjusted through a clearing house or otherwise, or persons engaged in accepting and procuring the transmission of orders for purchase or sale of shares of stock shall keep a record showing:

1. Date of transaction.
2. Line number (if at an Exchange).
3. Name of broker or salesman who executed the order.
4. Name of party to whom sold or from whom bought.
5. Number of shares dealt in.
6. Name or description of stock.
7. Price of stock, if without face or par value.
8. Amount or total market value of stock.
9. Face or par value of stock per share.
10. Tax paid on shares having face or par value.
11. Tax paid on shares without face or par value.
12. State tax paid, if any (optional).
13. Total amount to ledger (optional).
14. Folio number (optional).
15. Name of customer for whom sold or transferred, or from whom bought or transferred.
16. Number of shares loaned or borrowed.
17. Number of borrowed or loaned shares returned.
18. Method of settlement or adjustment.

From a practical point of view the broker is too hard pressed in running his business to answer technically all the questions asked by the Internal Revenue Department. An honest effort, however, is always made to impart whatever information is available and the report as submitted by the broker is reduced to its simplest form, covering fully the most important points in the questions asked on the report form.

Transferring Title to Stock

When corporations declare dividends on their securities, the payments are made to those whose names appear on the companies' books as stockholders of record as of certain dates. It becomes necessary, therefore, that all dividend-paying shares be transferred immediately upon their receipt to the name of the person who has paid for the shares, or to the name of the broker who has a lien upon both stock and dividends because of the indebtedness of his customer.

The customers retain the legal title to the physical property, although the indicia of title appear in the name of the broker. Of course the securities are owned by the customers who, however, cannot secure possession of them until they have paid the debit balances they owe the broker. When dividends are paid, and the checks are received by the broker, credit for the amount is given to customers according to their respective holdings.

A few days before the transfer books of a company close for dividend purposes, all stock of that company carried on margin and within the control of the broker is deposited with the transfer office for registration in his name.

Transfers are effected also in bonds, where it is desired to change their form from coupon to registered, or vice versa.

Securities "In"

All shares which are deposited for re-registration, or bonds which are lodged with the corporation for the purpose of

	WITHDRAWN					DEPOSITED				
	DATE OF WITH-DRAWAL	Nº OF SHARES	DESCRIPTION	CERTIF. Nº	REMARKS	DATE OF DEPOSIT	Nº OF SHARES	DESCRIPTION	CERTIF. Nº	REMARKS
	1930 2/16	30	✓ Anaconda	D 3110	for Jno. Jones	2/15	30	✓ Anaconda	D 2100	Ft. for Jno. Jones.

Form 7. Stock Transfer Register

changing their form, must be properly recorded by the broker so that he may have complete control over all securities for which he is responsible. For this purpose the stock transfer register (Form 7) is called into use. It is arranged to contain information concerning the nature of the transaction incidental to the transference or the depositing of securities. Columns are provided for entering the date of deposit, the number of shares or the par value of bonds, the description of the issue, the serial number of the certificate or indenture, and the name in which the old certificate was registered or the form of the old bond.

Securities "Out"

A few days after their deposit with the transfer office the new securities are ready for delivery to the broker. Upon presentation of the receipt issued by the transfer office the newly written certificates or bonds are delivered to the broker, whereupon he records in the stock transfer register the date upon which the new securities are received or the date of transfer; the number of shares or the par value of bonds; the description of the stock; and the serial number of the new issue, with perhaps the name in which the new certificate is written, or, if a registered bond, the name appearing on its face.

The securities ledger classifies by means of an alphabetical arrangement, while the transfer record groups the items under date of deposit and withdrawal, the deposit appearing on the right-hand page and the withdrawal on the left-hand page. By this arrangement the transfer record reveals at a glance just what stock has been transferred, what has been withdrawn, and what is at the transfer office. For verification purposes reference is again made to the securities record, which reflects the income and the outgo of securities from day to day.

CHAPTER X

DEPARTMENTAL AND OTHER RECORDS

Order Department

The purchases and sales sheets containing the reports of orders executed and written up by the order department are distributed as follows: One copy is retained by the order department; the margin department receives a copy, which is made the basis of a memorandum record of the commitments entered into by customers; a third copy is sent to the comparison department for the purpose of verifying ex-clearing house transactions; and a fourth copy is received by the clearing house department for verification through the exchange of clearing house tickets on active shares, which appear in units of 100 and multiples thereof. The record kept by the order department is the order book, in which original entries are made covering the orders of purchases and sales submitted by customers.

Comparison Department

As stated above, the comparison department receives from the order department a record of purchases and sales on all ex-clearing house items which are made the subject of comparison with the other brokers involved in the transactions.

All ex-clearing house transactions are compared by seller and buyer between the day of sale and 10 A.M. the next following business day. Article 24, Section 2, of the Rules of the New York Stock Exchange, says:

> It shall be the duty of the seller to compare, or to endeavor to compare, each transaction at the office of the

> buyer, not later than one hour after the closing of the Exchange. It shall be the duty of the buyer to investigate before 10 o'clock A.M. of the day after the purchase, each transaction which has not been compared by the seller. Neglect of a member to comply with the provisions of Section 2 hereof shall render him liable to a fine not exceeding $50 to be imposed by the Committee of Arrangements.

Section 5 states:

> Comparisons shall be made by an exchange of an original and duplicate comparison ticket; the party to whom the comparison ticket is presented shall retain the original if it be correct and immediately return the duplicate duly signed.

Comparisons are made for odd lots, ordinary bonds, and all hundred-share units not acceptable for clearance by the clearing corporation.

The actual date of purchase or sale appears at the top of the comparison slips, the name of the broker with whom the contract was made, the quantity of shares or bonds, the description of the securities, and the prices at which purchased or sold. The line for "Account Of" which appears on the slips is used for reference purposes, as where a floor broker who bought or sold for the account of another broker or firm has not at the time of making the contract disclosed the name of the broker for whom he acted, but does so when the comparison is presented at his office. As an example, let it be assumed that Mabon bought for the account of Adams, Burns and Conant $3,000 Belgium 6% Bonds of 1925, at 91. The trade was closed with Clarke, Ball and Company, who had not been informed by Mabon that Adams, Burns and Conant were the real principals for whom he had been acting. Therefore, if the principal broker endeavored to compare with Clarke, Ball and Company the effort might fail, unless Mabon's name were mentioned in connection with the transaction so that Clarke, Ball and Company could identify the trade without much difficulty.

The line reserved for "We Give Up" is used for information concerning the notice which Adams, Burns and Conant would serve upon Clarke, Ball and Company where the former acted for some other broker, Johnson and Company, and used the comparison method as a means of informing Clarke, Ball and Company so that proper comparison could be made between Johnson and Company and Clarke, Ball and Company—the two brokers who will respectively receive and deliver the Belgium bonds in question.

The sales comparison form is similarly arranged for the information and guidance of the interested parties.

Floor Brokers

Besides the purchases and sales record a commission bill memorandum book is kept in the comparison department, the function of which is to keep account of all transactions not executed by the Stock Exchange member but filled by other brokers not associated with the firm—that is to say, executed by what are known as floor brokers. These floor brokers are members of the New York Stock Exchange and are appointed as subagents to fill orders submitted by customers in the various Stock Exchange offices. For this service they charge a commission which is fixed according to the market price of the securities they have occasion to buy or sell. Thus, where the price of stocks purchased or sold is below $10, the floor brokerage is $1.25 for each hundred shares; on stocks selling at $10 per share and above, but under $125 per share, the commission charged is $2.50 per hundred shares bought or sold; on stocks selling at $125 per share and over, the commission rate is $3 per hundred shares (see Appendix B). At the end of the month the commission bills which are sent to the Stock Exchange firm are checked against the commission bill memorandum book for verification purposes.

In markets such as were experienced during the million-

share days of 1919, a great deal of the business entrusted to firm members was in turn given out or left with floor brokers for execution. Consequently it was very necessary to keep a proper record of all commissions charged by these brokers.

Not only do floor brokers execute orders for others, but firm members also accept orders from other brokers. Under these circumstances, they keep a memorandum of their "trades" the execution of which has been entrusted to them, so that they may properly receive the commission due on such executions. It is an established rule that where firm members have occasion to accept other business they should receive the regular remuneration. The commission bills receivable are listed separately, so that a record may be had of the earnings from commissions received or orders executed for other brokers. It falls within the province of the comparison department to keep proper account of such items.

Margin Department

The records to be found in the margin department are (1) a copy of the purchases and sales sheet, as stated before in discussing the distribution of the purchases and sales records, and (2) the margin sheets or cards which record the fluctuating values of securities bought or sold by customers on margin. The subject of margins is discussed in greater detail in Chapters VII and XIII.

Clearing House Department

The original purchases and sales record on clearing house trades is sent to the clearing house department. It will be remembered that the order clerk merely lists the number of shares, the description, the price, the time, and the name of the customer buying or selling. The information still lacking is concerned with the name of the broker or firm from whom the purchase, or with whom the sale, has been made. Between

the hours of 11 and 3 the Stock Exchange memoranda are sent to the office of the broker, so that the purchases and sales record may be made complete by filling in the missing information. From this completed data clearing house tickets are written up and sent out to the clearing house of the New York Stock Exchange. The following records will also be found necessary to the work of the clearing house department: a clearing house blotter, state and federal tax registers, and the stocks borrowed and loaned books. In the next chapter the intricacies of the clearing house department proper in its relation to the clearing house of the New York Stock Exchange will be explained.

The Cashier's Department

Among the books of account and records kept by the cashier will be found the ex-clearing house or cash blotter, a money borrowed book, a "failed to receive and deliver" memorandum book, a stock transfer register, a "box" record book covering both the active and the inactive securities, the securities record, and lastly, the dividend records.

Accounting Department

As might be surmised, the bookkeeping department in the brokerage office has charge of the general ledger, the customers ledgers, the private ledger (in charge of the head bookkeeper), and the supplementary journal.

It is also one of the duties of the accounting department to compile the purchases and sales notices sent to customers showing the charges and credits made to their accounts. The department also posts the blotters.

Customers' Notices

In the previous reference to the notices sent to customers reporting the execution of their orders it was stated that the

accounting department duplicates the purchases and sales invoices in such a manner as to make it possible for the carbon copy to be treated as a posting medium by the bookkeepers. According to one form in use the carbon copy of a purchase notice contains columns, with appropriate captions, for the date on which the instructions to the bookkeeper state that the customer whose name appears on the notice is to be charged, and for the number of shares, description of the stock, the price at which it was purchased, and the amount involved, which always includes the commission.

The sales notice, which is of a different color from that of the purchase notice, contains similar information, except that the bookeeper's attention is directed to the fact that the customer is to be credited with the proceeds of sale, which is arrived at by deducting from the gross amount involved, the commission and the state and federal taxes.

The notices of a day are arranged alphabetically and are distributed to the bookkeepers in charge of the respective ledgers, which are arranged in the same alphabetical sequence. Thus it becomes obvious that from the cash blotter referred to in Chapter V, only such items are posted as do not directly relate to purchases or sales made by customers.

Production Record

The broker employs agents for the purpose of developing his business much in the same manner as the merchant employs salesmen for a like reason. To keep account, therefore, of the productivity or efficiency of solicitors or "production men," it is necessary to keep account of the number of shares which are bought and sold as a result of their efforts. While they do not receive any credit or commission on what they produce, because such practice would be contrary to the rules of the Exchange, it is worth while for the broker to have a record of their productiveness as a basis on which to form his judgment

when the question of renewing the employment contract arises.

The productiveness of branch offices is capable of a check through a daily record of the amount of business influenced through their channels. Such a record is really in the nature of a cost record which on the one hand contains the items of expense incidental to the employment of solicitors or the conduct of branch offices, and on the other hand records the income for which the latter are responsible.

Method of Keeping Record

Where many solicitors are employed or branch offices maintained it is necessary to keep a memorandum book to show the margin of profit on which the production departments are operating. This record should be so kept as to present a review of the activities of each branch office and a yearly reconciliation, the résumé obtained from which will disclose the nature of income produced and determine the advisability of retaining the services of the solicitor or maintaining the branch office for another year.

This record is so arranged as to allow for the allocation of the daily business produced by each person or branch, which is stated in terms of commissions. At the end of the month a grand total is given. The items of commissions are compared with the items of expense, which include salaries, traveling expenses, and such outlays as are necessary in maintaining the branches.

Privileges in Stocks—"Puts"

Customers sometimes make commitments in the stock market by means of "privileges," known as "puts and calls." A "put" is an instrument issued by a person usually short of securities and written by him for the benefit of a third party or his order. It recites, in effect, that for value received the holder has the right to "put" or deliver to the seller a certain

number of shares of a specified stock at a specified price within a stated time from the date of making. The instrument also here states that "all dividends go with the stock." By this is meant that if the security referred to in the privilege should sell ex-dividend the deduction in the market price of the shares caused by the dividend declaration is considered in the determination of the price at which the privilege becomes operative. If the privilege is not exercised before the day of its expiration it becomes valueless, unless renewed for additional consideration.

To illustrate the operation of a "put," let it be assumed that A is short of 100 shares of Steel at 106 and that he enters into an agreement in writing, through the medium of a "put," giving B the privilege of delivering to A 100 shares of Steel at 103. The price on the day the instrument is issued is 106. From this it is seen that a "put" gives its holder the right to deliver certain stock several points below the then existing market price, at any time during the life of the "put." How, then, can the purchaser of this "put" realize a profit? A gain inures to the buyer of the "put" if the market price subsequently falls below the price at which the stock is deliverable. Reverting to the hypothetical transaction, B will deliver the 100 shares of Steel to A only in the event that the price declines below 103 by a margin which exceeds the sum of the consideration he pays A and the commission and taxes incidental to the completion of the operation. It will be advantageous for B, assuming that he has paid $100 for the privilege, to deliver or "put" the 100 shares of Steel only when he can purchase the stock at 101⅝ or lower. The method of determining this maximum purchase price is as follows: First, credit B's account tentatively with $10,300, the proceeds to be obtained from delivering 100 shares of Steel at 103. Next charge, also tentatively, the following items against B's skeleton account:

1. The consideration paid for the "put"..................	$100.00
2. The broker's commission charge to B in the event of delivering the stock to A........................	15.00
3. The stamp taxes incidental to such delivery ($2 New York State tax, $2 federal tax)..................	4.00
4. The commission charged by the broker in the event that B purchases these 100 shares of Steel at 101⅝......	15.00
5. Finally, the purchase cost of 100 Steel at 101⅝.......	10,162.50
Total debits	$10,296.50

Applying the debits against the credit of $10,300 results in showing a small profit, amounting to $3.50.

Let it be assumed that the price of Steel reaches 101⅝ and that B purchases through his broker 100 shares at this price. He then instructs his broker, with whom the "put" instrument is deposited, to deliver to A the shares he has purchased. Upon receiving the stock A pays the broker the price of 103 referred to in the "put," or the sum of $10,300. When so delivered A's account is credited for this amount and the transaction is completed.

"Calls"

A "call" is an instrument issued by a person who is long of a certain stock. It gives its buyer the privilege of demanding the number of shares of stock given in the instrument at the prices stated and within the time specified.

Let it be assumed that A is long of 100 shares of Steel at 106 and that he sells a "call" to B in consideration of $100. The price mentioned in the instrument is 109, and the "call" matures within 30 days. From the conditions as stated it may be inferred that "calls" are written above the market price prevailing when the instrument is issued.

Just as a "put" becomes operative only in the event that the price of the stock recedes to a certain point below the "putting" price, so a "call" becomes operative only when the market

price rises sufficiently above the price stated in the "call" to enable B to make a profit by the commitment.

Suppose Steel reaches 110⅜ and B sells 100 shares at this price. His account is then credited with the sum of $11,037.50. Inasmuch as the "call" which he has deposited with the broker enables him to receive the stock at 109, a gross profit of $137.50 results, from which are deducted:

1. The consideration paid to A, amounting to	$100.00
2. The commission charged by the broker upon the sale of the stock	15.00
3. The commission charged by the broker in receiving the shares upon the "call" for B's benefit	15.00
4. The taxes incidental to the delivery of the shares ($2 New York State tax, $2 federal tax)	4.00
Total deductions	$134.00

Thus it is seen that B makes a net gain of $3.50.

Advantages of "Puts and Calls"

In ordinary purchases and sales of stock without the adjunct of the "put" and the "call," the customer is compelled to deposit margin with his broker. If he is "long" and the market price declines after the purchase of stock, he is called upon for additional margin in order to comply with the standard requirements. If he is "short" and the price of his stocks advances, thus reflecting a "paper" loss, he is again called upon to deposit additional funds to replenish his impaired margin. In neither case can the customer determine the amount of his losses when committing himself to market operations.

The purchase of a "put" or a "call," involving a specified outlay in payment therefor, makes it possible for the customer to limit his loss absolutely to the amount expended in payment for the privilege. While limiting his loss in this manner, his gains, if gains there be, are limited only by two factors,

(1) the market price of the shares after buying the "put" or the "call," and (2) the time limit stated in the instruments. If the market price justifies the purchase of stock against a "put," or the sale of stock against a "call," the customer may realize large profits without having to run the risk attending marginal transactions. This use of privileges is of European origin, where a more conservative policy is assumed in stock-market operations. In this country the idea is comparatively new, and is followed usually by those who are familiar with the procedure of trading against privileges.

"Put and Call" Register

In order to record the material facts relating to the privileges deposited with him, the broker keeps a "put and call" register. This book contains the following information: description of stock, the due date of the privilege, to whom the stock is deliverable or from whom it is to be received, the delivery price, and the customers' names.

CHAPTER XI

THE CLEARING HOUSE SHEET

The Stock Exchange Clearing House

The discussion centering around methods of financing or settling Wall Street transactions would not be complete without an explanation of the clearing house system and the service which it renders the broker. So important is the institution that the voluminous business transacted daily in Wall Street would be so seriously hampered as to be practically impossible without its aid.

As the bank clearing house facilitates the adjustment and payment of the many millions of dollars of debits and credits arising during a given day, so the clearing house (Stock Clearing Corporation) of the New York Stock Exchange [1] assists in the adjustment and delivery of the many hundreds of thousands of shares of stock purchased and sold daily among its members.

Because of the enormous volume of trading in certain securities, the Stock Exchange established its own clearing house in 1892. To show the importance of its work, it is necessary only to turn to the date of December 5, 1919, when 290,800 shares of stock were traded in four issues alone, as follows:

41,000 shares of Trans-Continental Oil
46,300 shares of Pierce Arrow
152,500 shares of Southern Pacific
51,000 shares of Steel common

---

[1] The rules and regulations of the Stock Clearing Corporation of the New York Stock Exchange will be found in Appendix C. Their study is suggested in connection with the present chapter.

These transactions represented values approximating $26,813,000, to say nothing of the transactions in the other issues on that same day. In about four hours on the following delivery day, Monday, December 8, all settlements—deliveries and receipts—were effected. Thus it can readily be seen what great assistance is rendered by the clearance house.

Methods of the Clearing House

Each member of the Exchange is entitled to clearing house privileges, and when he avails himself of the right he is assigned a number which appears on his clearing house tickets and other clearing house documents.

For every purchase made on the Exchange there must be a bona fide sale, and both brokers—buyer and seller—must intend to receive and deliver the shares involved in the transaction. Every time a stock that has been put on the list regularly cleared through the clearing house is dealt in, there is an implied agreement that the trade is to be handled through that institution.

One block of stock might represent a purchase of 10,000 shares bought from fifty different brokers. The price of the stock might vary from one-eighth of a point to several points, depending upon the condition of the market at the time. It is a well-known fact that such huge purchases are consummated by a nod of the head or a discordant "Bought" or "Sold." In order to obviate any possible price disagreements in such offhand trading, each transaction is "compared" almost immediately after the close of the daily business. In ex-clearing house transactions, comparison may be made also before the opening of the market on the succeeding day.

Clearing house transactions are compared in the following manner: Slips called "clearing house tickets" are exchanged between buyer and seller through the medium of the clearing house. These tickets evidence the quantity, description, and

value of the shares sold. The seller's ticket, i.e., the ticket given to the purchaser by the seller, is a white one; the buyer's ticket, yellow. The seller's ticket has a perforated bill of sale attached to it, upon which the transfer tax stamps appear in canceled form.

These tickets are orders on the clearing house to deliver, in the case of the seller, or to receive, in the case of the buyer, 100 shares or multiples of 100 shares of a specified clearing house stock at the sale and purchase price shown on the tickets, the value of the shares being carried out in dollars and cents. It is obvious that where buyer and seller exchange tickets, the quantity, price, and money value should agree. If they do not, the matter is either adjusted the same afternoon, or else the shares are not passed through the clearing house that night. The item is then settled out of the clearing house, or it may be passed through on the following day.

The Clearing House Sheet

When the day's transactions have been completed, the clearing house tickets are written up on a sheet which is known as the "clearing house sheet." As shown in Forms 8a and 8b, this is divided into two parts. To the left, or on the Receive From side, are five columns in which are entered the data from the white tickets held by the concern which is preparing the sheet. In the first of these columns appears the broker's name, then, in order, the number of shares, the description of the stock which is to be cleared, the price basis as it appears on the white ticket, and the money value of the stock.

On the right-hand side of the clearing house sheet—the Deliver To side—information is listed from the yellow tickets which the concern received in exchange for its white, or deliver tickets. In other words, the sheet when sent to the clearing house by a broker furnishes information to the authorities of that institution concerning his purchases and

STOCK CLEARING CORPORATION (NIGHT CLEARING BRANCH) No. 17

NEW YORK, Dec. 8, 1920 OFFICE ADDRESS, 91 Broadway CLEARING SHEET OF Adams, Burns and Conant

RECEIVE FROM	SHARES	SECURITY (N.Y.S.E. Abbreviation)	PRICE	✓	VALUE	DELIVER TO	SHARES	SECURITY (N.Y.S.E. Abbreviation)	PRICE	✓	VALUE
1 J. Moor & Co	100	R	76¾		7675	51 Redman & Co	200	AR	64¼		12850 —
2 James Wallace	100	X	103⅝		10362 50	52 C. M. Short & Co	100	U	125		12500 —
3 E. F. Horton & Co	100	AR	63⅛		6312 50	53					
4						54					
5						55					
6						56					
7						57					
8						58					
9						59					
10						60					
11						61					
49						99					
50						00					
Totals 500 shares $43450						Totals 500 sh. $43450					
	300				$ 24350 —		300				$ 25350

ENTER ON THIS SHEET ONLY THOSE TRANSACTIONS FOR WHICH TICKETS HAVE BEEN EXCHANGED. THE TICKETS MUST AGREE OR BOTH PARTIES WILL BE FINED.

Form 8. (a) Clearing House Sheet

sales of the day, together with a list of stocks borrowed or returned. Hence, in the column reading "Deliver To," the broker lists officially the orders he makes upon the clearing house, directing delivery of the shares involved. The other four columns correspond to those on the left-hand side, having the headings: Shares, Security, Price, and Value.

At the bottom of the clearing house sheet the following directions appear: "Enter on this sheet only those transactions for which tickets have been exchanged," and "The tickets must agree or both parties will be fined." Observance of this latter injunction assures an agreement as to the quantity, money value, and description of the stock on the clearing house sheets of both receiving and delivering brokers.

Supplementary Clearing House Sheets

According to the rules of the New York Stock Exchange clearing house, a broker may file supplemental clearing house sheets for items about which it is not certain that tickets have been exchanged. There is no positive way of determining whether broker A issued a ticket to broker B for an item claimed by the latter. Owing to the lateness of the hour and the tremendous quantity of detail work, as well as the time limit set for filing the sheets with the clearing house, a question might arise in the mind of one broker as to whether or not the other broker has entered a certain item upon his sheet. Wherever this doubt exists, a supplemental sheet may be filed which contains the individual item in question. The purpose of this becomes quite obvious, as in the event that an item is entered by both parties upon their respective clearing house sheets, a full accounting and reconciliation in the clearing house is possible. If, on the other hand, one of the parties has omitted the item, the one filing the supplemental sheet is not penalized, since the validity of the clearing house sheet proper is not impaired by the inclusion of doubtful items.

STOCK CLEARING CORPORATION (NIGHT CLEARING BRANCH) No. 17

NEW YORK, Dec. 8, 1920 OFFICE ADDRESS, 91 Broadway. CLEARING-SHEET OF Adams, Burns and Conant

RECEIVE FROM	SHARES	SECURITY (N.Y.S.E. Abbreviation)	PRICE	√	VALUE	DELIVER TO	SHARES	SECURITY (N.Y.S.E. Abbreviation)	PRICE	√	VALUE
1 Recap:–	300	–			$24350	51 Recap:–	300	–			$25350 –
2						52					
3						53					
4						54					
5						55					
6 Bal. to Deliver	100	√ AR	63		6300	56 Bal. to Receive	100	√ R	77		7700 –
7	100	√ W	125		12500	57	100	√ X	104		10400
8						58					
9						59					
10 Balance Draft					300	60					
11						61					
49						99					
50						00					
200 shares $18,800–						200 shares $18,100					
	500				$43450		500				$43450

ENTER ON THIS SHEET ONLY THOSE TRANSACTIONS FOR WHICH TICKETS HAVE BEEN EXCHANGED. THE TICKETS MUST AGREE OR BOTH PARTIES WILL BE FINED.

Form 8. (b) Clearing House Sheet—Recapitulation

Balancing the Clearing House Sheet

It will be remembered that the function performed by the clearing house is to facilitate transactions in clearing house stocks between its members, by expediting the delivery and receipt of such stocks and by effecting settlement when so doing. In case receipt and delivery of the same kinds of shares appear on the clearing house sheet, the transactions are set off against each other when the clearing house sheet is balanced. This is done for the purpose of determining the balance of stock to be received from and delivered to the brokers whom the clearing house may designate, the receipt and delivery to be actually made upon the following day.

In much the same manner as a debtor or creditor bank in New York pays or receives a credit on the books of the federal reserve bank in settlement of its voluminous transactions, so the broker receives or delivers through his clearing house the net shares purchased or sold, paying or receiving cash against them as the circumstances may require.

On the Receive From side of the clearing house sheet shown in Forms 8a and 8b are listed:

100 shares of Reading (R)	purchased at	76¾
100 shares of Steel (X)	" "	103⅝
100 shares of American Smelters (AR)	" "	63⅛

On the Deliver To side are listed:

200 shares of American Smelters (AR)	sold at	64¼
100 shares of Union Pacific (U)	" "	125

The only set-off is the American Smelters stock to the extent of 100 shares, leaving as the Balance to Receive, 100 Reading and 100 Steel. The Balance to Deliver is 100 Smelters and 100 Union Pacific.

Balancing-Stock Sheet

In large offices where the clearing house department needs to be extremely well organized on account of the big turnover, an accounting expedient resorted to is the balancing-stock sheet. This is so arranged that all clearing house stocks are listed in the center of the sheet. To the left and right are as many blank columns as there are clearing house sheets covering the transactions of the day. Opposite each stock is entered the number of shares bought or sold in the order of their appearance on the respective clearing house sheets referred to. Thus, if clearing house sheet number 1 shows 500 shares of Steel purchased, that fact is recorded in the first column on the balancing-stock sheet opposite Steel. If on the 6th clearing house sheet 5,000 shares of Steel appear as having been sold, that fact is entered in the 6th column on the balancing-stock sheet opposite Steel. All columns are footed both across the page for the individual stock items and at the bottom of the page. These cross-footings and total amounts are then compared with the clearing house sheets and assist materially in locating any differences that might exist.

Clearing House Deliveries

How are the 200 shares of American Smelters and 100 shares of Union Pacific referred to in the section preceding the last to be obtained by the broker for delivery? He may have the shares in his vault or elsewhere, or, if the sales are short sales, he will very likely borrow the stock the next morning to effect delivery. Wherever one customer is long of stock which is carried in the broker's vault or in bank loans and another of the broker's clients has made a short sale, the broker is at liberty to use the long stock for the purpose of making delivery—in other words, he need not borrow that which is already available, but may hypothecate the securities of his customers.

Clearing House Delivery Prices

The question naturally arises, when looking at the clearing house sheet shown on pages 81 and 83, as to the prices at which the Reading and Steel stocks are to be received and as to the prices at which the Smelters and Union Pacific stocks are to be delivered. Let it be supposed that 50,000 shares of Reading have been purchased during the day by all the brokers, at prices ranging from 76¾ to 78. Which of the prices in this range should govern as the settlement price? One broker might choose the actual purchase price of 76¾ as the settlement price for the 100 shares he has bought, but this obviously could not serve as the settlement price for all the 50,000 shares, some of which have been purchased at higher prices, ranging up to 78. The same difficulty and haggling over settlement prices would be experienced by each broker whose name appears on the clearing house sheet. To prevent this difficulty the clearing house selects for each stock one common settlement price which it prints on the stock ticker at about 3:30 P.M. each day. These common prices, covering all clearing house issues, are known as the "clearing house delivery prices," and all net receipts or deliveries, as evidenced by the clearing house sheets, are settled at these prices. Fractions are eliminated from the delivery prices, which approximate the closing bid or offer.

Referring to Form 8b, the net deliveries of 100 American Smelters and 100 Union Pacific which appear on the Deliver To side of the clearing house sheet are carried over to the Receive From side opposite the sidehead "Balance to Deliver," while the net receipts are carried over to the Deliver To side opposite the sidehead "Balance to Receive." When this is done, the total number of shares, including the carry-overs, will be 500 on both sides. Furthermore, it will be found that the entries balance in the same way in the case of each stock.

At this point the clearing house delivery prices are applied

to the Balance to Receive and Balance to Deliver stocks. On the date given in Form 8b the price for Smelters is 63, for Union Pacific, 125; for Steel, 104; and for Reading, 77. Hence, the Steel stock is received at 104, or $10,400, and the Reading at 77, or $7,700. The Smelters is delivered at 63, or $6,300, and the Union Pacific at 125, or $12,500.

The next step is to foot the two value columns. In doing this it will be found that the credit side of the sheet totals $43,450, and the debit side $43,150. This difference of $300 is in favor of the broker whose sheet is shown. It represents the amount the clearing house is indebted to him and according to the rules he makes out a draft on the clearing house for this sum, the Bank of the Manhattan Company being the drawee. The draft becomes bankable if, after the sheet goes through (cleared), the manager of the clearing house countersigns the instrument. If the sheet were to show a balance against the broker, he would have to send to the clearing house, at the time he deposited the sheet, a check for the balance made payable to the Bank of the Manhattan Company.

Receive and Deliver Tickets

To complete the clearing house sheet there are attached to it clearing house tickets, known as Balance to Receive and Balance to Deliver tickets. The Balance to Receive tickets are made out for the amount of each kind of stock to be received on balance, and the Balance to Deliver tickets are made out for the amount of each kind of stock to be delivered on balance. In the case of the sheet shown in Forms 8a and 8b only two Balance to Receive tickets are necessary, one for 100 shares of Reading and the other for 100 shares of Steel, while two Balance to Deliver tickets are necessary to evidence the broker's net delivery obligation, one for 100 American Smelters and the other for 100 Union Pacific.

On the Receive tickets the broker advises the clearing house

that he "will receive the following balance of stock at the delivery price":

100 Reading	at	77
100 Steel	"	104

On the Deliver tickets the broker states that he "will deliver the following balance of stock at the delivery price":

100 Smelters	at	63
100 Union Pacific	"	125

These four balance tickets are called for at the clearing house the following morning—Saturday excepted—and the face of the Receive tickets then reveals the name or names of the brokers whom the clearing house has designated as the delivering brokers, stating the number of shares which each one is to deliver. On the Deliver tickets appears the name or names of the brokers whom the clearing house has designated as the receiving brokers. Between 10 A.M. and 2:15 P.M. all these balances are either received or delivered, thus settling the transactions. The smallest quantity of stock which is received or delivered through the clearing house is 100 shares; no broker is called upon to settle for fractional lots.

The Broker's Clearing House Balance

Before leaving the subject of the clearing house sheet let us consider the $300 which the broker has received from the clearing house. Does this sum represent a profit to the broker? The answer, in order to be clearly understood, must be given indirectly by means of the following explanation: Let us again refer to the purchase prices of the Reading, Steel, and Smelters (Form 8a) and compare them with the delivery prices of the same day (Form 8b). The Reading stock has been bought by Adams, Burns and Conant for $7,675. By reason of the delivery or clearing house price being 77, they have to pay

$7,700 instead of $7,675, or $25 more than they really should. The broker who has sold this stock for $7,675 receives $25 more than is due him, being compelled also to use 77 as his clearing house price. Deducting the less from the greater side, his sheet reflects a debit to the clearing house of $25, while the sheet of Adams, Burns and Conant would show a draft for this amount if the Reading transaction were the only item cleared. The Steel purchase for $10,362.50 is handled in the same manner, but here $37.50 is the amount adjusted. The 100 Smelters bought at 63⅛ for $6,312.50 is offset on the opposite side by 100 Smelters sold at 64¼ for $6,425, making a profit of $112.50. It is quite obvious that Adams, Burns and Conant have a right to draw for this amount, for the reason that it happens to be the only way to collect the profit. Another 100 shares of Smelters was sold at 64¼, which must be delivered at 63. On this item Adams, Burns and Conant are underpaid by the receiving broker, but they are entitled to collect from the clearing house the difference of $125. As the sale price for Union Pacific is the same as the delivery price no adjustment is necessary. Thus Adams, Burns and Conant have a claim on the clearing house for a total of $300, and the clearing house in turn has a claim for an equal amount on the other brokers. This $300, therefore, represents no profit, but merely an adjustment necessary because of the discrepancy between the delivery and the purchases or sales prices.

If the sheets of the other brokers were analyzed for the purpose of determining the amount Adams, Burns and Conant should collect from the clearing house, it is safe to say that a reconciliation could be had very easily. In fact, the machinery of the clearing house does just this analytical work to prove the correctness of all items appearing on the sheets.

The two sides of the sheet are now in balance, since the draft for $300 equalizes them. In preparing the sheet for deposit with the clearing house, the shares are checked up and

footed. The clearing house tickets, balance tickets, and the draft accompany the sheet to the clearing house.

Recapitulation Sheet

After transactions are entered on the clearing sheet (Form 8a) the balances of stocks To Receive and To Deliver, together with the money balances, are entered on a recapitulation sheet (Form 8b). This is in accordance with the rules of the clearing corporation. The purpose of this latter sheet is to furnish the Day Branch of the clearing corporation, the function of which is explained in the next section, with the amounts of the balances as above stated, so that that organization may know what securities and sums of money are on balance, due to or due from the respective clearing brokers. These balances appear on the following day's charge and credit tickets delivered to the Day Clearing Branch by the respective brokers. (See Appendix C, "The Stock Clearing Corporation of the New York Stock Exchange.")

The Day Clearing House

In describing the operation of the Day Branch of the Stock Clearing Corporation, reference must again be made to the Balance to Receive and Balance to Deliver tickets that are filed with the clearing house sheet by members in accounting for the transactions coming under the jurisdiction of the clearing institution.

It was stated in a previous section of this chapter that these balance tickets are completed by the clearing house supplying the filing broker with the names of those from whom and to whom securities are to be received and delivered upon the following delivery day.

For practical purposes let it be assumed that there are to be accounted for upon the next delivery day the following balances of stocks:

Receive:

From A	500 U. S. Steel	at 90	....	$45,000.00
" B	100 A. B. S.	" 70	....	7,000.00
" C	200 A. G. W.	" 145	....	29,000.00
" D	300 Rq.	" 100	....	30,000.00
" E	400 Union	" 128	....	51,200.00
Total..	1,500		....	$162,200.00

Deliver:

To F	100 R. B. C.	at 78	....	$7,800.00
" G	1,000 So. Pac.	" 100	....	100,000.00
" H	900 So. Ry.	" 31	....	27,900.00
" J	600 Erie	" 18	....	10,800.00
Total..	2,600		....	$146,500.00

A total of 1,500 shares is to be received against a money value of $162,200, and a total of 2,600 shares is to be delivered against a money value of $146,500. Under the old regulations, before the clearing house was organized in its present form, members were compelled to issue checks in payment of the balance of stocks received and collect in payment of the balance of stocks delivered, the checks being certified as a rule where the sum involved was above $5,000. This made the matter of financing transactions a rather burdensome operation, particularly during million-share days when the heavy transactions made necessary the certification of many millions of dollars between the hours of 10 A.M. and 2:15 P.M.

Under the new system, all that is necessary is for the broker to receive or pay the difference between the total charges and the total credits. Assuming in the example above that all securities are received and delivered on the next delivery day, the amount required to settle the difference is $15,700. The steps in the operation are as follows:

1. Filing with the Day Clearing Branch a charge and a credit ticket containing all the information called for in the requirements of the clearing corporation, to wit, the clearing house number of the filing member, his name, the brokers from whom shares are to be received or to whom they are to be delivered, the quantity, the delivery price, the value, the total number of shares, and the total dollar amounts to be charged and credited.

2. Accompanying the charge and credit tickets are two slips, showing only the dollar total with which the member is to be charged and the dollar total with which he is to be credited at the Day Clearing Branch.

3. Before 10 A.M. the charge and credit tickets, together with the charge and credit slips showing only the dollar values, are filed with the Stock Clearing Corporation.

4. Between 10 A.M. and 2:15 P.M. deliveries are made, and to the stock so delivered a formal bill is attached, filled out in duplicate.

5. After the deliveries have been effected, a final receipt is filed by each member claiming a balance from, or owing a balance to, the Stock Clearing Corporation, i.e., the difference between the total of his charge and credit tickets. In the illustration given above, a certified check for $15,700 is affixed to the receipt form and sent to the corporation. When the balance favors the broker, a draft is affixed to the final receipt ticket, which, after being signed by the manager of the Stock Clearing Corporation, is returned to the broker and deposited by him.

"Failed to Deliver" Stocks

The foregoing illustration has been worked out upon the assumption that all securities due and owing are delivered. Suppose, however, that a broker fails to deliver against some of his contracts. In that case, he is compelled to file with the

corporation a ticket for each "failure" and the value of such "failed" stocks for which he requested credit that morning is deducted from his net credits or added to his net debits. The draft which he claims or the check which he sends in settlement at the end of each day is drawn in accordance with the adjusted differences occasioned by the "failure." As an example: If broker K fails to deliver to broker F 100 shares of Republic Iron and Steel against a value of $7,800, K files with the clearing corporation on the day of failure to deliver a Failed to Deliver ticket, and that amount of credit for K is deducted, thus making it necessary for him to send to the clearing corporation a check for $23,500 instead of $15,700. Liberty bonds, which have been added to the general list of clearing house securities and for which a separate clearing sheet is filed each night, are cleared by the Day Branch in precisely the same way as stocks.

The establishment of the Day Branch of the Stock Clearing Corporation has saved a great deal of unnecessary financing by the broker. Further plans have been formulated with a view to eliminating the still existing hardship attendant upon borrowing and returning money from banks.

CHAPTER XII

BALANCING THE BLOTTERS

Balancing the Clearing House Blotter

The clearing house blotter, as stated in Chapter V, is one of the two records from which purchases and sales are posted to the individual customers' accounts, the ex-clearing house blotter being the other record. We shall now consider the method by which the clearing house blotter is balanced.

In reviewing the columnarization of this record (Forms 9a and 9b), we find that the first five columns on either side are practically identical with the first five columns of the receive and deliver sides, respectively, of the clearing house sheet. That is to say, the column which provides for the name of the selling broker, under the caption "Of Whom Bought," corresponds to the column on the clearing house sheet which is headed "Receive From." Thus, the name of the broker with whom tickets have been exchanged against purchases appears again in the blotter. In the same way, in both forms the columns headed Shares or Number of Shares, Description of Stock, Price, and Amount or Value, correspond and are self-explanatory.

In order that the clearing house blotter may operate as a check upon the sheet, all the transactions—the number of shares, nature of stock, and the amount involved, as evidenced by the sheet—must appear again upon the blotter. In effect, a copy of the sheet is preserved in blotter form, for in every detail the sheet and blotter agree.

The methods of balancing the clearing house blotter and the clearing house sheet are so much alike that very little need be added to the discussion of the balancing of the clearing house

sheet in Chapter XI other than a treatment of the entries found in the blotter that are not found on the clearing house sheet. For this purpose we shall take the transactions under the date of Friday, December 5, discussing them in connection with the clearing house blotter of Monday, December 8.

Purchases:

100 Reading, at 76¾ for John Jones
100 Steel common, at 103⅝ for Fred Smith
100 Smelters, at 63⅛ for Richard Ross

Sales:

200 Smelters, at 64¼ for Richard Ross
100 Union Pacific, at 125 for Fred Smith

Glancing at the blotter we find that the first five columns, as far as the purchases are concerned (Form 9a), express the transactions fully up to the point of cost to the broker, but the commission on the purchases must be added to determine the cost to the customers. The commission column reflects this additional charge, and the customer total column combines the amount and commission columns. The broker's total commission on the 300 shares purchased during the day is $45.

The sales, so far as the first five columns are concerned, bring the transactions up to the point of the proceeds received by the broker (Form 9b). From these the commission and tax must be deducted in order to arrive at the proceeds which are to be credited to the accounts of the customers. The proceeds of the Smelters sale are $12,850 less $30 for commission and $8 for taxes, or the net sum of $12,812. In the case of the Union Pacific, the net proceeds are $12,500 less $20 for commission and $4 for state and federal taxes, or $12,476. The commission column totals $50, and the tax columns $12. The total commission earned on the 600 shares bought and sold during the day is $95.

RECEIVE

Dec. 8, 1920

OF WHOM	NO. OF SHARES	DESCRIPTION	PRICE	AMOUNT	COM'N	CUSTOMERS (Long)	CUSTOMERS (Short)	GENERAL	ACCOUNT
J. Moor + Co	100	✓ R	76¾	7 675	15	7 690 –		–	John Jones
James Wallace	100	✓ X	103⅞	10 362 50	15	10 377 50		–	Fred Smith
E. F. Horton + Co	100	✓ AR	63⅛	6 312 50	15	6 327 50		–	Richard Ross
					45				
Balance to Deliver :-									
	100	✓ AR	63	6 300	–				
	100	✓ U	125	12 500	–			18 800	✗ Cl. House
Balance Draft	–	–	–	300	–			300	✗ " "
	500	✓		43 450	✓	24 395		19 100	
						Recap:			
						24 395			
						19 100			
						43 495 ✓			

Form 9. (a) Clearing House Blotter (left)

DELIVER

Dec. 8, 1920

TO WHOM	NO. OF SHARES	DESCRIPTION	PRICE	AMOUNT	COM'N	TAX N.Y.	TAX Fed'l.	CUSTOMERS (Long)	CUSTOMERS (Short)	GENERAL	ACCOUNT
Redman & Co	200 ✓	AR	64¼	12 850	30	4	4	12 812 -		-	Richard Ross
C. M. Schort Co	100 ✓	U	125	12 500	20	2	2	12 476 -		-	Fred Smith
					50 45 95	6	6			95	Commission a/c
										6	State Tax
										6	Federal Tax
Balance to Receive :-											
	100 ✓	R	77	7 700	-	-	-				× Cl. House
	100 ✓	X	104	10 400	-	-	-			18 100	× " "
	500 ✓			43 450 - ✓				25 288 -		18 207	
								Recap:			
								25 288			
								18 207			
								43 495 ✓			

Form 9. (b) Clearing House Blotter (right)

7

The first step in balancing the clearing house blotter is to foot the individual monetary columns of the Receive page, which, if cross-footed, should equal the footing of the customers long total column and thus prove the correctness of the work. In footing the Deliver page the correctness of the work can be established by adding the tax and commission columns to the footing of the customers long total column, which should then equal the footing of the amount column.

In order to effect proper posting to the Customers control account due notice must be taken of the classification of customers' purchases and sales. Purchases may be either for long account or to cover short commitments previously contracted. Sales may represent the disposal of long securities formerly purchased, or newly made short commitments. Therefore, unless this classification of customers control columns is introduced, the total footings of the control columns would be posted to the same account in the ledger. This would result in the long and short commitments being grouped together under the same caption and lead to the mixture of asset and liability accounts, which would be in need of classification before it was possible to compile a proper balance sheet.

To illustrate the procedure, if John Jones sells 100 shares of United States Steel short for $10,400, his short account will reveal the fact and the credit thus created will be part of the Customers Short control account in the general ledger. If Jones buys in his shortage, his short account will be debited and become part of the total charges posted to the debit of the Customers Short control account.

If Smith purchases 100 Smelters at 63, his long account will be debited and the debit thus created will be made part of the Customers Long control account in the general ledger. Upon the sale of the Smelter shares Smith's long account will be credited and a corresponding credit will appear in the Customers Long control account.

If, however, Jones, already short of 100 Steel, should now purchase 200 shares instead of 100, then the value of 100 shares will be charged to his short account and the value of the second 100 shares will be charged to his long account. In dividing Jones's purchases and entering the items in the respective customers long and customers short control columns in the blotter, the totals of the control columns will be posted to the general ledger.

Should Smith, already long of 100 Smelters, sell 200 shares thus going short of 100 shares, then the customers control columns on the Deliver page of the blotter should properly classify the sales by making an entry for the proceeds of the first hundred shares to the credit of the customers long column and an entry for the proceeds of the second 100 shares to the credit of the customers short column.

As a result of this practice, the balances of the two control accounts in the general ledger will agree with the sum total of all the individual debit and credit balances appearing in the underlying customers ledgers.

In the illustration given in Forms 9a and 9b the "short" columns were not entered, for the sake of simplicity in exposition.

As a second step, the total commission shown on the Receive page is carried into the commission column on the Deliver page. The total of the two is then carried to the general column of the Deliver page, and the account to be credited with this sum is that of Commission. The totals in the tax column are treated in the same manner, the accounts credited being Federal and State Revenue Stamps.

The next step in balancing the blotter is the adjustment of the clearing house balances. The delivery prices are used on both pages, the respective amounts being entered in the amount column, and the grand total of these amounts being carried thence to the general column, including the draft for $300.

Under the caption "Account" appears "Clearing House." If all Balances to Receive and Balances to Deliver are carried over to the general column, and all the columns are footed, the sum of the customers and the general columns on the one page must equal that on the other. The total number of shares must also agree on both pages and must agree with the footing of the shares columns on the clearing house sheet as well. A glance at Forms 9a and 9b, will show that such is the case with the transactions given. The close relation between the clearing house blotter and the clearing house sheet is thus clearly seen.

It should be noted that the cross marks appearing against the clearing house items indicate that these are not to be posted to the general ledger. The reason for this is apparent enough if we remember the rule that all clearing house differences, whether debit or credit, are self-adjusting. The balances appearing on the clearing house blotter are treated finally in the ex-clearing house blotter which is discussed in the next chapter.

The entry in the blotter of such items as commission and taxes is not necessary if the bookkeeper posts from the duplicate purchases and sales notices sent to customers and referred to in Chapter X, instead of resorting to the old method of posting customers' accounts from the blotter. Where the new method of posting is in use, the clearing house blotter contains the same items as the clearing house sheet which it supports, and in addition the name of the customer for whom the purchase or sale has been made. The customer's name is entered merely as a means of tracing the item to the purchases and sales sheets in the event that such reference is necessary.

Loan Blotter

All clearing house items which are borrowed and loaned, or called and returned, are kept separate and distinct from transactions resulting from customers' activities. The loaned and borrowed items are entered on separate blotter sheets,

known collectively as the loan blotter. It should be clearly understood that this loan blotter is part of the general clearing house blotter and is included for balancing purposes. It is merely used for the purpose of segregating items arising out of transactions incidental to the buying and selling of stocks, i.e., stocks borrowed, loaned, called, or returned.

Since such items carry with them the element of interest or premium, such interest or premium items must be posted by the bookkeepers. In fact, the entire loan blotter is used by the bookkeeping staff for posting purposes. It is to be remembered that transactions concerning stocks borrowed or loaned are items which must be recorded from the original book of entry, which in this case is the loan blotter.

Balancing the Ex-Clearing House or Cash Blotter

The ex-clearing house blotter has heretofore been usually referred to as the cash blotter. This name was given to the book because it concerns itself primarily with handling cash items.

On the Deliver page of the blotter the first entry made on a particular day is the cash balance at the bank carried forward from the previous day.

The next entries cover the balances of securities to be received or delivered against payment as a result of the clearing house sheet filed the day before.

The third set of entries are those reciting the purchases and sales of all ex-clearing house securities, such as odd lots, bonds, and unlisted shares.

The fourth group of entries reflects the cash received from customers as margins, the receipt of dividends and interest on bonds, payment of cash to customers, payment of expenses, and interest paid on bank loans.

The fifth and last entries record the receipt of securities from customers and from transfer offices, the delivery of

securities to customers, and the deposit of securities with transfer offices.

The balancing of the cash blotter is, with a few differences, similar to that of the ordinary commercial cash book. On the Receive page the amount columns are posted as are also the commission, customers, and general columns. The total of the amount column represents the actual cash disbursed. On the Deliver page the amount, commission, tax, customers, and general columns, are posted. The footing of the commission column on the Receive page is carried over and added to the footing of the commission column on the Deliver page. The sum total of the commissions is then carried to the general column, as is the total of taxes, set up respectively as "N. Y. State Tax" and "Federal Tax." The total of the amount column represents all moneys received. Hence the difference between the cash received, including the balance with which the day was begun, and the cash disbursed, as shown on the Receive page of the blotter, represents the new cash balance in the bank. For balancing purposes the bank balance is carried over to the Receive page in red ink. The footings of the amount columns on both pages of the blotter will now agree. The bank balance appearing in red on the Receive page will be the first item carried to the Deliver page on the ensuing day.

There remains but the posting of the blotter. As the first step in this procedure the commission and the tax accounts are credited with the item posted from the general column on the Deliver page. The customers columns on the Receive page and on the Deliver page are then posted respectively to the debit and credit of the Customers control account on the general ledger, while individual posting to the personal accounts of customers is made in the customers ledgers. The bank or Cash account is now debited with the amount of the bank balance as it appears on the Receive page, since in doing

so the asset, "cash," is spread upon the broker's books. The bank or Cash account will be credited with the same balance on the ensuing day as was carried over from the preceding day, and at the close of business on this second day the new bank balance will be debited to the Cash account. The effect of these debit and credit postings to the Cash account is tantamount to balancing the Cash account each day.

Let us follow the balances over a period of several days. Assume that the firm of Adams, Burns and Conant bank at the Manhattan Company and that the bookkeeper has posted from the Receive page, as of January 2, a balance to the debit of the bank amounting to $75,000. From the cash blotter of January 3 he will post from the Deliver page a credit to the bank of $75,000 and a debit from the Receive page of $69,000, which is taken to be the new balance as of January 3. On January 4 he will post again from the Deliver page a credit to the bank account amounting to $69,000 and from the Receive page the new balance, say of $73,000. As a consequence of these daily postings, the last debit to the bank account represents the balance of the deposit account.

CHAPTER XIII

BROKERAGE TRANSACTIONS—OPERATING METHODS

Typical Transactions

In order that the principles of brokerage accounting may be clearly understood it is expedient to treat representative transactions of the average brokerage house and show the order of entries from the inception of the business to the closing of the books of account.

The typical transactions in securities of which daily record is made may be summarized as follows: purchasing and selling; borrowing and lending; calling, returning, and renewing loans of stock.

The following transactions have a direct bearing upon financing purchases and sales: clearance loans, and collateral bank loans.

Other matters to be considered are: interest and premiums in connection with money borrowed or loaned and stocks borrowed or loaned, which reflect costs or earnings incidental to financing purchases or providing securities for delivery against short sales made by customers; commission and interest on customers' transactions which are additional factors affecting earnings; mark-ups and mark-downs, as they affect stock loans; Failed to Receive and Failed to Deliver items, which pertain to omissions to complete contracts between brokers; dividends credited or charged to customers; the interest on bond purchases or sales; the computation of interest on customers' accounts and the rendering of monthly statements to customers.

Partnership Contributions

The tangible assets contributed to a partnership in the brokerage business are usually cash, securities, or the use of Stock Exchange memberships. Frequently persons are given an interest in the business because of the clientele they command, or because of the special services they can render. Neither is it unusual for persons to become special partners and finance the business without taking an active part in the general management of the affairs of the partnership. A Stock Exchange member who is a special partner of a firm cannot confer any of the privileges of the Stock Exchange upon the firm.

The contribution of cash does not raise the same questions as do security or membership contributions, for in the latter cases the terms of the partnership agreement or the Stock Exchange rules must govern the method of entry upon the books or the extent of credit given to the partners contributing securities, or to the one contributing membership in the Stock Exchange.

Security contributions may be accepted under various conditions. The partners may covenant to accept the securities at a stipulated value for the firm's investment account, thereby occasioning an entry debiting the Investment account and crediting the partner's capital account; or they may agree that the stipulated value of the securities shall fix the sum which the contributing partner agrees to keep good during the period of the partnership. In the latter case actual credit to the latter's capital account is deferred until the securities are sold, when the cash received is made the basis of an entry debiting Cash and crediting the partner's capital account.

If from the time of depositing the securities their price declines 20% from the value originally agreed upon by the partners, the partner who contributed them must make good the loss by contributing additional securities. The principal

point to remember here is that the contributing partner does not receive any credit in his capital account until he realizes upon his investments. Meanwhile he is entitled to all increments which his securities bring, such as dividends, subscription rights, and interest. If the securities are finally sold and bring less than the sum which he has covenanted to contribute, the difference is supplied by him in the manner indicated by the terms of the partnership contract. This manner of treating the security contributions to capital is to be preferred to the other method, because it does not make the other partners parties to the speculation.

Stock Exchange Memberships

A Stock Exchange seat entitles the member to certain privileges of the Board, which he can confer upon the firm of which he is a partner, unless he is a special partner. The seat cannot be held in the firm's name, since the Exchange only considers its own member's relationship to itself. Any misconduct of the firm is generally considered the misconduct of the Exchange member. If he is suspended or expelled the firm is automatically ruled off the Board and can do no further business in an official way with other Exchange houses until its Exchange representation is restored.

In view of this it is difficult to conceive how a partnership can lay claim to the Stock Exchange membership in fee. However, a value is placed by most brokerage houses upon the privilege conferred by the member of the Board, and it is that value which forms the basis of the entry charging "Exchange Privileges," or Stock Exchange Seat account, and crediting the capital account of the partner.

Among several Stock Exchange concerns the value of the privilege is not spread upon the books, thus evidencing more correctly the status of the contribution, i.e., the intangible rather than the real value which a member in the Stock Ex-

change turns over to his firm. And for this privilege or Exchange representation an interest in the partnership is granted to him. The firm must not supply the funds with which the seat is purchased and a Stock Exchange member may represent only one local firm at a time.

Inception of a Brokerage Partnership

On January 3, 1920, A. Adams, B. Burns and C. Conant form a partnership under the firm name of Adams, Burns and Conant. The object is to conduct a stock brokerage business. Adams contributes capital in the form of a Stock Exchange seat valued at $100,000 and $100,000 in cash. Burns contributes $100,000 in cash. Conant's contribution consists of securities the par value of which is $200,000, with an accepted market value of $190,000, it being the intention of the parties to regard the latter amount as Conant's full contribution. The securities so given are listed below:

$100,000 Union Pacific 1st 4% Bonds.....	(market value)	$95,000.00
50,000 United States Steel 5% Bonds.......	" "	50,000.00
50,000 Southern Pacific Refunding 4% Bonds	" "	45,000.00
Total		$190,000.00

All profits and losses are to be divided equally among the partners. Books of account are to be kept to which all partners are to have access. The depository is to be the Bank of the Manhattan Company.

Opening Entries

The salient facts to be recorded in the opening entries in the ex-clearing house or cash blotter (Forms 10a and 10b) relate to capital contributions. On January 3 these entries appear: Adams' capital account is credited with $200,000, of which $100,000 appears as credit for his cash contribution

EX-CLEARING HOUSE OR CASH BLOTTER

DELIVER

Jany 3, 1920

TO WHOM	NO. OF SHARES	DESCRIPTION	PRICE	AMOUNT	COM'N	TAX N.Y.	TAX Fed'l.	CUSTOMERS	GENERAL	ACCOUNT	NUMBERS
		Cash							100 000 —	A. Adams c/a	
		"							100 000 —	B. Burns c/a	
	Stock	Ex. Membership							100 000 —	A. Adams c/a	
		Investments							190 000 —	C. Conant c/a	
									490 000		
									490 000		

Form 10. (a) Ex-Clearing House Blotter (left)

EX-CLEARING HOUSE OR CASH BLOTTER

RECEIVE

Jany 3, 1920

OF WHOM	NO. OF SHARES	DESCRIPTION	PRICE	AMOUNT	COM'N	CUSTOMERS	GENERAL	ACCOUNT	NUMBERS
A. Adams		Stock Ex. Seat					100 000 –	Exchange Memberships	
C. Conant +	100 M	U.P. Ref. 4%		95 000 –			95 000 –	Investment a/c.	B 61100/61199
"	50 M	US Steel S.F. 5%		50 000 –			50 000 –	"	C 101112/36 C 10282/10306
"	50 M	So. Pac. Ref. 4%		45 000 –			45 000 –	"	119625/119674
		Balance					200 000 –	Manhattan Co.	
							490 000		
							490 000 –		

Form 10. (b) Ex-Clearing House Blotter (right)

and $100,000 for his Stock Exchange seat. Burns's capital account is credited with $100,000, with the explanation that the contribution is in the nature of cash. Conant's capital account is credited with $190,000, composed of the three security items. All these entries appear on the credit or Deliver page (Form 10b) of the ex-clearing house or cash blotter.

The debit entries are made on the debit or Receive page of the same blotter (Form 10a) as follows: Stock Exchange Membership account is charged with $100,000, the description of the entry referring to Adams' contribution. Investment or Securities account is charged with $190,000, the contribution of Conant. Needless to say a full description of the securities is recorded so that proper posting can be made in the ledger.

There remains only an item of cash to be considered to complete the transactions incidental to partnership matters. The total of cash received from the parties amounts to $200,000, and instead of the Cash account being charged as is customary in making an entry in commercial books, the name of the depository bank, to wit, Bank of the Manhattan Company, appears in the cash blotter as the account to be charged. Hence the entries if journalized would appear as follows:

Debits:

Stock Exchange Membership	$100,000.00
Investments or Securities	190,000.00
Manhattan Company	200,000.00
Total	$490,000.00

Credits:

Adams' Capital Account	$200,000.00
Burns's Capital Account	100,000.00
Conant's Capital Account	190,000.00
Total	$490,000.00

Another Method of Treatment

If a private ledger is kept for the purpose of withholding from clerks information of a personal nature, the ex-clearing house blotter will show on the Receive page all the items as heretofore stated, except that cross references to the capital accounts will be omitted. On the credit or Deliver page one item for $490,000 will appear for the credit of "Private Ledger" controlling account, the details of which will be shown in the private journal and posted to the private ledger.

Instead of journalizing the Exchange Membership and Investment account in the blotter, the supplementary journal can be used for the same purpose. In case the supplementary journal is used, only the cash to the debit of the Bank of the Manhattan Company appears in the blotter while the complement credit is to Adams' and Burns's capital accounts; or if a private ledger is in service, the credit is to the "Private Ledger" controlling account.

Customers' Purchases and Sales

On January 4 the purchases for customers were as follows:

500 Steel at 104, for the account of A
100 Union Pacific at 125, for B
200 Pennsylvania at 41, for C
100 Anaconda at 77, account of D

The sales of the day were:

2,000 Reading at 77, account of E
500 Smelters at 63, account of F
800 Anaconda at 77, account of G
200 American Beet Sugar at 95, for A

The odd-lot purchases were:

10 American Can, preferred, at 101 for H
30 Anaconda at 77, for the account of J

The odd-lot sales were:

10 Union Pacific at 125, for K
25 Brooklyn Rapid Transit at 20, for L

The cash received on January 5 was:

$2,500	from A
1,000	from B
1,000	from C
4,000	from G
100	from H
250	from L

The purchase of 100 Anaconda for the account of D will be taken up by him; that is to say, he will pay the brokers the sum of $7,715 and will have delivered to him the 100 shares which he bought. The transaction entered into by J, embracing 30 shares of Anaconda at 77 will also be paid for and the stock delivered to him. K will deliver 10 shares of Union Pacific against his sale. All the transactions will be settled on the next following delivery day, namely, January 5, so that proper provision must be made for the receipt and delivery of the shares involved.

Financing the Transactions

When a merchant commits himself to the purchase of merchandise for cash he keeps constantly in mind the amount which he will be compelled to pay upon delivery of the goods to him. He completes his banking arrangements usually before the goods are received. Unlike the merchant, the broker pays little regard to the total cost of purchases made by his customers, for it is his ability to borrow freely on securities which makes his task an easy one as compared with the merchant's. If of the 100-share lots of clearing house listings there is an excess of purchases over sales, the broker merely gives orders after 5 P.M. to lend stocks to the other brokers desirous of borrowing them. This is attended to by the broker's clerk on the

Stock Exchange. Failing to lend the stock, he can easily arrange the day following, with his bank or any other lender, to borrow from 60% to 80% of the market value of securities which he pledges as collateral.

Borrowing Stocks Against Short Sales

The question of short selling has always been one difficult to comprehend by the average layman. A word of explanation will not be amiss at this point, since the operation involves a technical matter which requires a simple exposition in order that the subject may be more fully understood. Let us take for purpose of illustration a storekeeper who is engaged in selling hardware. One of his customers desires to buy a certain style of hammer of which the dealer finds he is out of stock at the moment. Not wishing to lose the sale, he borrows the tool from his next-door neighbor, also engaged in the hardware business. The first dealer pays the second one the cost price of the article, and later, when he receives a shipment, he returns a hammer of the same style and number as the one which he borrowed and receives in return the amount of money which he paid to his neighbor. This completes the transaction.

Now let it be assumed that A, believing that a certain security is selling at a price disproportionately high compared with its true value, instructs his broker to sell 100 shares of that particular stock. At the time of giving the order to his broker he does not own the shares he directs to be sold, and this, technically speaking, makes him short of the stock. As he has sold something which does not belong to him, he must eventually repurchase it, that is, "cover" his commitment. His broker, however, is in the meantime compelled to obtain the shares to make delivery against his customer's short sale, as it should be remembered that according to the rules of the Stock Exchange deliveries must be effected the next day against all sales made in the "regular way."

Just as the broker lends his excess purchases, so other brokers lend theirs, and in this particular case the stock the broker requires for delivery purposes is obtained in the loan crowd, which assembles after 3 P.M. on the floor of the Stock Exchange. The stock is borrowed there, and on the next business day is delivered at the market price. When the customer eventually repurchases, or covers, his short commitment his broker comes into possession of the stock which he previously borrowed. He is now able to return the shares to the broker from whom he previously borrowed, and he receives in return the amount of money which he paid to obtain the borrowed stock. The transaction is now closed.

Let us consider the stock-borrowing requirement due to the short sales made by customers on January 4. The purchases and sales book reflects a shortage of 2,000 Reading, 500 Smelters, 800 Anaconda, and 200 American Beet Sugar.

As these issues are all clearing house stocks, they are borrowed in the loan crowd on the afternoon of January 4 for settlement on January 5. When this is done and all the clearing house purchases and sales are written up in the clearing house blotter, the next steps, which are taken simultaneously, are the preparation of the clearing house sheet and the balancing of the clearing house blotter. Besides this it is necessary to enter the borrowing transactions in the stocks borrowed and loaned book (Forms 4a and 4b), giving the name of the lender and a full account of the terms on which the stocks are so borrowed. The securities ledger will contain a record of these borrowed securities, giving all necessary information.

On January 5, the day on which the transactions of January 4 are settled, the receipts from the clearing house are 500 Steel, 100 Union Pacific, 200 Pennsylvania, and 100 Anaconda. Let us assume that the broker was unable to lend these shares advantageously the day before.

Mr. D., for whom 100 shares of Anaconda were purchased,

remits $7,715, the amount of his debit balance, against which payment delivery is made of 100 shares of this stock. The receipt of cash from D, together with the receipts from the clearing house as above stated and the odd-lot transactions, are all to be found in the ex-clearing house or cash blotter of January 5.

Odd-Lot Transactions

A word is necessary here to explain the manner in which short sales in odd lots are treated. According to the purchases and sales book in which such listings are recorded, the broker is called upon to deliver 25 shares of Brooklyn Rapid Transit. Assume that the broker does not have a 25-share certificate available for delivery, and as odd lots have no loan market he cannot borrow the shares. He may then "fail" to make delivery with the consent of the buyer. If, however, the buyer demands delivery, the seller is compelled to split up a 100-share certificate in the transfer office of the company and thus effect delivery through transfer, as it is called; or the buyer may give 75 shares change for a 100-share certificate.

If the broker fails to deliver these 25 shares of Brooklyn Rapid Transit, it entails the making of an entry on the Receive or debit page of the ex-clearing house blotter to show that the Failure to Deliver account is charged with 25 shares of Brooklyn Rapid Transit, involving $500, and D's account is credited on the Deliver page in much the same manner as though delivery were actually made. In other words, the customer's account is credited either through the blotter or by means of the duplicate notice of sale (whichever system is in use) whether or not the transaction is settled. If the transaction is not immediately settled by delivery that day, then a debit entry must appear to take the place of cash, which ordinarily would be received if delivery were made. This debit entry is charged against the Failure to Deliver account. When even-

tually the stock is delivered, the credit item appears for the account of Failure to Deliver and a debit to the Cash account completes the double entry.

The 10 shares of Union Pacific sold at 164 for the account of K have been received, thereby allowing their delivery. The 30 shares of Anaconda purchased at 77 have been transferred to the name of J, who has paid $2,314.50. As a rule the transfer of securities is not made until the check given by the customer is cleared by the bank.

Routine Records

The stock transfer register is necessarily called into use at this point to evidence the deposit of stock with the transfer office.

The customers' transactions are entered in the customers ledger, the entries being taken from the duplicate notices of purchase and sale, to which reference was made in Chapter X, or from the blotters if they are used as posting media for customers' items. The other accounts, with the captions of Stock Borrowed, Commission, Federal Revenue Stamps, and New York State Revenue Stamps, are posted in the general ledger. If only one ledger is used, as is the case in some brokerage houses, all the transactions are posted to the general ledger.

The revenue stamps accounts are credited with the amount of the federal and New York State tax stamps consumed in the process of stock delivery. This presupposes an expenditure for revenue stamps, which when purchased are charged to these accounts. The revenue register is also called into operation to express the transfer of stock by sale of the securities dealt in on January 4.

The "depot box" book further evidences the deposit in the vault of securities that are in the possession of the brokers and that are being carried by them for the accounts of their clients.

Customers Margin Book

The customers margin book is now the only record which has not been treated in connection with the transactions of January 4. F's margin sheet shows that he is short of 500 shares of Smelters at 63. If, for purposes of illustration, we assume that the closing price of Smelters is 68 (this being the last price of the day), then the account will reflect a market debit approximately $2,500. This debit is arrived at in the following manner: F will at one time or another be compelled to purchase this stock against his shortage. If he "covered" now at the prevailing price of 68, he would lose 5 points on 500 shares, or $2,500. To this paper loss must be added the amount of commissions, and the tax. Since there is no evidence of F depositing any margin on January 5, the brokers will call upon him to remit at once sufficient funds in order to protect themselves on his commitment. As $2,500 has already been lost at the present market price of the stock, the amount he will be called upon to send will be at least $7,500. This sum is arrived at in the following manner: 10 points on 500 shares, which equals $5,000, plus the $2,500 deficit makes a total of $7,500. This margin will tend to adjust the difference between 63 at which F sold and the current market price, 68.

The account of G is short of 800 Anaconda at 77, against which he has deposited a margin of $4,000, or 5 points on each hundred shares. As this margin is insufficient according to the standard requirements of today, he will be called upon to make good the deficiency of 5 points by remitting a check for an additional $4,000. If the price of Anaconda should rise to 80, he will be called upon to make further payments to cover the difference between 77 and 80, or 3 points on 500 shares, which amounts to $1,500. After these remittances have been made G's account will be well secured, for a margin of 10 points for securities selling in the neighborhood of 70 is generally considered ample.

The account of E does not require comment as it is similar in nature to that of F.

A is long of 500 shares of Steel and short of 200 American Beet Sugar. Two margin sheets are necessary to determine A's standing in the market. Assuming that the price of neither stock undergoes change, he is requested to deposit a margin of, say, 10 points, or $5,000, on his "long" position and none against his "short" position. However, he is called upon to deposit additional funds in the event that the price of his short securities advances more rapidly than the price of his long securities. The rule is that a customer is required to margin fully the account in which his position predominates, either long or short, and the other account only to an extent sufficient to offset paper losses. If the deposit by the customer is not large enough on the basis of this method of calculation to secure the broker against fluctuations, additional funds are requested.

In the case of B, the price of Union Pacific has advanced 2 points, so that the account has a margin of $1,300, or 13 points, on a hundred shares. This result is arrived at as follows: This stock has been purchased at 125 and the present market price is 128, thus showing a profit of $300. As B has deposited with his brokers $1,000, his total margin is now $1,300.

C's account has a margin of only 5 points, as he has deposited but $1,000 against the purchase of 200 shares of Pennsylvania stock at 41. The usual request for additional margin is therefore made. The margin accounts of H and L are comparatively simple and require no comment.

The entry of the foregoing transactions completes the record for January 4. The work involved is usually distributed among the various departments in the office so that it may be completed with the greatest dispatch. The work in the cashier's department is concluded after delivery time, or 2:15 P.M., and

embraces generally the borrowing of money to complete the banking requirements.

Call or Demand Loans

It will be recalled that 500 shares of Steel, 100 Union Pacific, 200 Pennsylvania, and 100 Anaconda are received through the clearing house on January 5 against purchases made on the previous day. These receipts involve the payment of about $79,000. While the cash balance of brokers is sufficient to pay for these securities, the question is purposely raised here as to how the broker arranges the financing of his purchases when he is compelled to borrow money. In such a case he requests the Stock Exchange member of the firm before 3 P.M. to borrow funds in order that the firm's bank balance may be improved. Let us assume that the loan is for $65,000. Banks in Wall Street usually employ a Stock Exchange member to lend their surplus funds on call or demand. The broker arranges to borrow the sum required and the lending bank's representative notifies it that $65,000 has been loaned to the broker in question, whereupon the borrowing broker sends collateral to the bank and gets the loan. The collateral amounts to at least 120% of the sum borrowed. The money is deposited with the Bank of the Manhattan Company in which the broker carries his deposit. The account credited on the books of the broker is Money Borrowed and contains the details of the transaction—the amount borrowed, the rate of interest to be paid, and the collateral contained in the loan.

Final Entries

The final operation in the day's work is the balancing of the blotter, bringing down on the Receive page the balance of cash with which the bank is charged. It is evident, therefore, that the bank account appearing in the general ledger, together with any petty cash, comprises the usual Cash account. The

bank balance is immediately carried to the Deliver page of the next day's cash or ex-clearing house blotter so that the amount charged to the bank on January 5 will be credited to the bank account on January 6, and the new bank balance of the second day is charged as heretofore.

The bookkeeper posts all purchase and sales entries to the respective ledger accounts under the date of January 5, which is the value date, and this completes the recording of the cash transactions entered into on January 5.

CHAPTER XIV

BROKERAGE TRANSACTIONS—PURCHASES AND SALES

The Daily Routine

The following purchases and sales are made by Adams, Burns and Conant on January 5:

Purchases:

25	Brooklyn Rapid Transit at 20, for L
500	Smelters at 66, for F
3,000	Anaconda at 77, for G
500	Steel at 100, for A
200	American Beet Sugar at 91, for A
10,000	Reading at 76, for E
600	Pennsylvania at 40, for C
5,000	Union Pacific at 125, for M
600	Anaconda at 77, for O

Sales:

500	United States Food Products at 80, for P
400	Illinois Central at 90, for C
700	New Haven at 35, for F
200	Pennsylvania at 40, for R
600	Rubber at 125, for D

A glance at the above transactions shows that the 25 shares of Brooklyn Rapid Transit sold January 4 by L are now covered or bought back. If the broker failed to deliver this stock within the regular delivery time, he is now prepared to make delivery. When he receives the shares he sends them to the broker who is awaiting receipt and credits the Failed to Deliver account according to the rule set forth in the preceding chapter.

Turning now to the 100-share transactions, we find

that F has covered his shortage of 500 Smelters. By purchasing 200 American Beet Sugar, A has also covered his shortage. We also observe that G has purchased 3,000 shares of Anaconda, covering the 800 shares of Anaconda which appeared in his short account and thereby reversing his position in the market to the extent of 2,200 shares of the same stock. This makes G's account long. The same holds true in the case of E, who has purchased 10,000 shares of Reading. Being previously short of 2,000 shares he has reversed his position in the market, going long of 8,000 shares. In the cases of both E and G new ledger accounts showing the present longs are necessary. Their short accounts are charged with the number of shares representing the shortage, and the long accounts are charged with the remainder.

Borrowed Stock

On January 4, in order to make possible the delivery against short sales, Adams, Burns and Conant were compelled to borrow:

2,000 Reading
500 American Smelters
800 Anaconda
200 American Beet Sugar

It is apparent that when the customers cover their shortages the brokers will, upon receipt of the shares so purchased, be in a position to return the borrowed stock. Accordingly, having no further use for the stock, they inform the respective lending parties that they will return it.

Stock Returns

At this point it is necessary to explain the manner in which stock returns are made. Stock loans in general are both returnable and callable at any time, provided reasonable notice is given to the other broker. Loans involving clearing

house issues are settled on the clearing house sheet. Thus a return of a clearing house stock also necessitates an exchange of clearing house tickets. On the sheet the returns are treated in the same manner as a sale, for the reason that an order is therein given to the clearing house to deliver certain shares.

Whenever stocks are borrowed, cash is paid; and conversely, whenever stocks are loaned, cash is received. As the broker loaning the stock profits from the use of the money which he receives against such loans, he pays interest at an agreed rate. Taking a concrete case, let it be supposed that the 500 shares of American Smelters mentioned in the foregoing transaction were borrowed at 2½%, which was paid by the lender; that the clearing house, or delivery price that day for Smelters was 63 (the clearing house prices govern in all stock loans cleared on the clearing house sheet), and that $31,500 was the amount paid by the borrower. As the stock was borrowed on the sheet of January 4, the transaction went "through" on January 5. If returned on the sheet of January 5 this second transaction would be settled on January 6, and one day's interest at the annual rate of 2½%, or $2.19, would be charged on $31,500. The amount on the clearing house ticket and sheet would read $31,502.19.

On the other hand, let us suppose that this same loan extended over a period of 20 days and that the rate varied from 2% to 4½%. In that case when the stock was returned the amount of interest would be arrived at in this manner: 2½%, say, for 4 days, plus 2% for 5 days, plus 3% for 8 days, plus 4½% for 3 days. The total interest on $31,500, the amount involved, would be $50.31, so that the clearing house ticket would be made out for $31,550.31.

Short Sales

Returning to a consideration of the purchases and sales effected on January 5, we find by consulting the purchases and

sales book that it will be necessary to borrow the following stocks, representing short sales:

500 United States Food Products
400 Illinois Central
700 New Haven

Notice is sent to the "floor" of the Exchange to do the necessary borrowing.

On this day 200 shares of Pennsylvania have been sold for the account of R, but the sale is partly offset by the purchase of 600 shares of the same security for C. If no Pennsylvania had been so bought, delivery against the short sale could have been made by using the 200 shares of Pennsylvania which were purchased for C on January 4 and deposited in the vault on January 5.

Cash Items

On the sale of 600 shares of Rubber by D delivery was promised by the customer, making this transaction one that is commonly referred to as a "cash item." This term, as used here, means in the case of a purchase that the customer will pay for the stock upon delivery, and in the case of a sale, that he will actually deliver the shares to the broker.

Financing Purchases

During inactive markets, or to use the more common expression, when business is quiet, the cashier's department can quickly determine the amount of cash necessary to finance the purchases of the day. But when the market is very active and the volume of business is large, with indications pointing to an excess of purchases over sales, the order is issued after 3 P.M. to lend as many as possible of the securities which have been purchased on balance. The cash position of the firm is seldom referred to, because as a rule the broker carries

a moderate balance at his bank and trusts to his ability to lend stocks in the open market to obtain the cash necessary to take up and pay for the shares coming in upon the following business day.

In our present example, the excess stocks are offered for loaning purposes in the afternoon of January 5. This excess consists of 2,800 shares of Anaconda, 8,000 shares of Reading, 5,000 shares of Union Pacific, 500 shares of Steel, and 400 shares of Pennsylvania.

All stocks so loaned are entered on the clearing house sheet in preparation for the January 6 settlements and thus offset a great many of the purchases contracted for.

Stock Loans Returned

Securities borrowed against short sales that are now covered are returned to the lending broker. If, when the shares were borrowed, the Stocks Borrowed account was charged in order to set up the asset account to which the borrowing gave rise, it follows that when the borrowed stocks are returned the same account must be credited.

Conversely, when stocks are loaned the operation gives rise to a liability which is entered on the Deliver page of the blotter and is credited to the Stocks Loaned account. When the shares are recalled, or "called," as it is ordinarily expressed, the entry is made on the Receive page of the blotter, debiting the Stocks Loaned account.

As a result of this procedure, the appearance of the account Stocks Loaned on the Receive page of the blotter indicates a "calling" of the shares that have been loaned. The appearance of the account Stocks Borrowed on the Receive page is to be interpreted as an initial transaction originating upon the day on which the entry appears. When the account Stocks Borrowed appears on the Deliver page of the blotter, it evidences the return of shares previously borrowed. Also, when the

account Stocks Loaned appears in the blotter on the Deliver page, it bears testimony to the fact that a new transaction has been entered into by the broker.

In connection with stocks returned the element of interest or premium must be considered. It should be remembered that stocks borrowed at interest means that the broker borrowing the shares advances funds equal to their market value and usually receives interest on the advance.

Where stocks are loaned the transaction involves the receipt of money, on which interest is generally allowed and which is paid when the stocks are called. The interest is entered separately in the amount column of the blotter, and in carrying the total interest to the general ledger column the interest on Stocks Borrowed account and Stocks Loaned account appears under appropriate headings. The interest received on borrowed stocks is posted to the credit of the Interest on Borrowed Stocks account in the general ledger, while interest on loaned stocks, which reflects a payment by the broker, is posted to the debit of Interest on Loaned Stocks. Very often both kinds of interest items are respectively credited and charged to a general interest account.

Commission Account

Where the old form of blotter is used and the customers' purchases and sales are not posted from the duplicate purchases and sales notices, the commissions on various purchases and sales appear in the blotter and the total of the commissions is posted to the Commission account or to the controlling account, Private Ledger, in the general ledger, the sum appearing in the general ledger column.

Revenue Stamps Account

Under the old system of blotters the total of the revenue stamps affixed to bills of sale, which appears on the Deliver

page in the blotters, is posted in a lump sum to the revenue accounts under the general ledger column in the blotters.

If, however, the duplicate purchases and sales system is in operation, the total consumption of revenue stamps is given to the cash blotter clerk, who makes an entry in that blotter, from which the posting is made to the Revenue Stamps account, New York State or federal.

Incidental Entries

Proper record is made in the stocks borrowed and loaned book to evidence the return of the borrowed stocks, the calling of loaned stocks, and any other transactions made in connection with stocks borrowed or loaned.

The securities ledger and the "box" record show respectively the daily changes occurring in the condition of securities, while the revenue stamp register records the consumption of revenue stamps.

The cash blotter of the day will contain entries for all cash received as margin from customers, and for all payments made to them. The blotter is then balanced in the usual way and sent to the bookkeeping department for posting.

Premium and Interest on Stock Loans

In order to bring out the principle of premiums and interest on stock loans, let it be supposed that the 2,800 shares of Anaconda are loaned at 1/64 premium. This means that not only is the loan of stock made free of interest charges, but that the borrowers of the stock actually pay the lenders a consideration, known as a premium, of 1/64 of 1% on the basis of $100 value per share. Let us further suppose that the Reading stock is loaned "flat," which means that no interest is paid, and that the Union Pacific is loaned at 2% interest, to be paid by the lenders.

On both the call and return of the stocks interest is com-

puted for the length of time that the money has been used. As shown above, in the case of the called stocks three distinct conditions may exist—the stocks may have been loaned "at a premium," "flat," or "at interest." Turning to the loaned section of the stocks borrowed and loaned book, we learn that the Anaconda has been loaned at a premium of 1/64, i.e., 1/64 of 1%, or at the rate of $1.56 per day per hundred shares, Saturdays, Sundays, and holidays being always excluded. The premium on the 2,800 shares of Anaconda for one day is $43.68. The broker who is returning the money deducts, therefore, $43.68 from the principal of the loan. In other words, the Anaconda shares having been loaned at 77, the broker's clearing house ticket reads: 2,800 Anaconda, $215,556.32 ($215,600.00 – $43.68).

The premium on these 2,800 shares of Anaconda should be credited to a Premium account, although many brokers credit it to the Interest account. The amount is carried to the credit side of the clearing house blotter under the appropriate heading. This Premium account should be a clearing account, because the amount of premiums received represents earnings that belong to the customers who are long of the Anaconda shares. Those who own the 2,800 shares loaned out are entitled to their respective parts of the $43.68 received by the broker. In other words, if A is long of 1,400 shares he is entitled to $21.84; if B is long of 700 shares, he is entitled to $10.92; and the customers long of the remainder are entitled to their pro rata credits.

The Stocks Loaned account, which is charged with stocks recalled, will apparently contain a discrepancy to the extent of $43.68. This point may perhaps be more clearly expressed by saying that the general ledger column on the Receive page of the clearing house blotter will contain a charge of $215,556.32. If to this sum is added $43.68 and the total is carried into the general ledger amount column, the Stocks

Loaned account will be properly charged with $215,600, representing the loan value of 2,800 shares of Anaconda.

The Reading stock has been loaned "flat," and is therefore returned without any interest being paid. The stock has been loaned for $608,000 and is returned against the receipt of that amount of money.

The Union Pacific stock was loaned on January 5 and is called on January 6. One day is therefore the time on which interest at the rate of 2% is charged. The principal being $625,000, the amount of interest is $34.72, which should be charged to Interest on Stocks Loaned account.

Varying Interest Rate on Stock Loans

If stocks which have been borrowed or loaned are neither returned nor called for a considerable period, the interest rate may vary from day to day, depending upon the prevailing loaning rates of stocks. It is to the advantage of the lender to reduce the interest rate wherever possible. The opposite is true in the case of the borrower. In the one instance, a lower rate means that the lender will pay a smaller amount for the use of money obtained on the stocks loaned, while in the other case, the borrower will earn more on the advance he makes.

On some days call money is higher than on others. Unless there be a large short interest in the market, which means a great demand for stocks by borrowers, the rate at which stocks will be loaned will be governed largely by call-money conditions. If the original loaning rate on Steel was 4% and it falls to 3¼%, then the lenders of the stock in order to reap the benefit of the decline must notify the borrowers that the rate on their Steel is renewable at 3¼%. If, on the other hand, the loaning rate of Steel rises to 5%, then it is necessary for the borrowers to serve notice on the lenders that the renewal rate has been increased to 5%. Unless such

notice is given by the borrowers or the lenders, the last renewal rate obtains until properly changed. This matter of renewing rates is attended to each day after 3 P.M.

It should be stated here that the lending of securities has absolutely no bearing on the customers' accounts other than that they enter into the calculations of the broker when deciding upon the rate of interest he should charge or allow on customers' balances.

Collateral Bank Loans

Frequently there exists no borrowing demand for securities. Inactive issues are generally in no demand whatever. Under such circumstances money cannot be had on the usual stock loan. Bonds are very rarely sold short and seldom, if ever, figure prominently in the activities of the loan crowd. How, then, are the purchases of inactive issues and bonds to be financed? Relief is to be found in the collateral bank loan. The banker or broker who lends on collateral security generally desires a high grade of collateral, i.e., securities having a ready and available market. Collateral loans made on industrial stocks usually command a slightly higher rate than loans on railroad stocks or first-class bonds. Frequently a mixture of the two kinds of collateral is acceptable, while sometimes the money lender refuses to make a loan unless a better kind of security is given. Some industrial stocks command a money loan of 60% of their market value, while railroad stocks and bonds will command 80%. If a purchase of a poor class of security is made by a customer, the marginal requirements are gauged by the size of the loan which can be obtained on the security when pledged as collateral.

It is to be observed that most collateral demand loans are of short duration, most of them running under 30 days. The call-money rate on these loans varies. Here the lender of the money is charged with the duty of notifying the

borrower when he wishes to increase the rate. Likewise the borrower, when the rate decreases, must notify the bank and arrange with it for the lower rates.

Time Loans

Collateral loans are made also on time, the usual period being 30, 60, or 90 days. These loans are made at a fixed and unchanging rate of interest for each loan. The interest is generally paid at the maturity of the loan, but in some cases the lender demands the accrued interest at the end of each month. The point in connection with accruals from the borrower's standpoint will again be treated in Chapter XVI under "The Income Statement."

Coupons

When coupon-bearing bonds are deposited as collateral security against a bank loan, the maturity coupons belong to the owner of the bonds and whenever a coupon day arrives the borrower should request the bank to cut the matured coupons from the bonds and deliver them to him or collect them for his account, as he may desire.

Equity in Collateral Loans

In a rising market the equity which the borrowing broker has in his securities is increased, sometimes to such an extent that he is allowed to reduce his collateral. In a declining market the equity is decreased, and the broker is called upon to deposit additional security to afford adequate protection for the loan.

Clearance or Day Loans

Brokers in general have excellent banking connections. The relation between banker and broker is so close that usually

the former is kept well apprized of the latter's business conditions and stability. Where this is the case, the "clearance loan" is a common method of meeting the broker's financial needs.[1]

On some days the receipts of securities assume large proportions. The broker knows before 10 o'clock each morning the amount he will need to carry him through the day. His balance is seldom large enough in itself to cope with a day of extremely large business. To meet such a condition he gives his bank in the morning a note known as a "clearance loan," for a sum large enough, when added to his own balance, to pay for all securities he expects to receive that day. Later in the day he arranges for a demand or a time loan to provide more permanently for the securities paid for through the medium of the clearance loan, and uses the proceeds to pay off the clearance loan at the end of the day. At least 50% of all stock purchases by brokers are financed by means of these temporary clearance loans.

The Mark-Up and Mark-Down

The "mark-up," as explained briefly in Chapter VIII, is a notice of an increase in the price of stocks, issued by the lender of stocks to the borrower. If the market rises very rapidly such adjustments will be frequent. In fact, a given stock, in a widely fluctuating market, may be adjusted to market value several times during a day.

The mark-up operates in favor of the lender, because it gives him a greater amount of money on his stock. On the other hand, it works against him from the standpoint of interest, for the larger the principal borrowed, the greater the amount of interest to be paid thereon.

---

[1] For an interesting discussion of the clearance loan, see *The Evening Mail* of New York, November 12, 1913, in connection with the decision of the United States Supreme Court in the Hocking Coal and Iron case.

The "mark-down" is a notice of a fall in the price of stocks, given by the borrower of such stocks to the lender. The mark-down is a feature of a declining market and operates in favor of the borrower by reason of his receiving back part of the principal which he has given in exchange for the borrowed stocks. But the mark-down operates against him from the standpoint of interest, for the reason that while the principal is being continuously decreased by the mark-downs issued by him, the interest received will be on a smaller principal.

Both mark-ups and mark-downs are issued between 10 A.M. and 3 P.M. From the standpoint of the blotter, they are handled in the following manner:

In the case of the mark-up, the broker who is lending the securities will charge Stocks Loaned (regardless of the nature of the stock) with the amount of the old principal, making due allowance for interest charges, and will credit the account with the new principal, which represents the increased market value.

The mark-down is treated in practically the same way. But here the broker issuing it is borrowing securities. The Stocks Borrowed account is therefore credited with the old principal, making due allowance for all interest credits, while the same account is charged with an amount representing the new market value of the issues.

In the case of a mark-up, the borrowing broker gives the lender a check for the difference between the old principal, less the interest to which the former is entitled and the new market value of the stock. This interest, on the books of the broker "marking up," is charged to the account Interest on Stocks Loaned. The same interest, from the standpoint of the borrowing broker, represents earnings and is credited to Interest on Stocks Borrowed.

All changes due to a mark-up or a mark-down must be

reflected in the corresponding sections of the stocks borrowed and loaned book. Either has the effect of a new transaction and is so treated.

Interest on Bonds Purchased or Sold

Bonds are traded in on the Exchange on the basis of "and interest," the purchasing broker paying interest on the principal from the last coupon date. The exception to this rule is to be found in income and debenture bonds and bonds of defaulted corporations. These bonds are quoted "flat," which means that no interest is calculated on them. To illustrate a transaction in a bond quoted "and interest," let it be assumed that a $1,000, 5% bond, with interest payable January 1 and July 1 of each year, is purchased July 31 at 99⅞. The amount which the broker pays on this purchase is $998.75 plus the interest at the rate of 5% for 30 days on the principal of $1,000. The broker's customer is charged with the total of these two amounts plus the commission of $1.50. The same method of calculation is used in the case of a sale, but here the customer receives the total of the first two amounts less the broker's commission. There is no charge for revenue stamps on bond sales.

Interest on Time Options

The delivery rules of the New York Stock Exchange also contain the following reference to the calculation of interest on time option contracts, or purchases or sales of bonds made for delivery in more than 3 days: "Interest specified in the bond shall be computed to include the day of sale; and thereafter at the rate of interest agreed upon." As a general practice no definite interest rate is agreed upon between the two contracting parties, with the result that usually no interest is charged after the day of sale.

Dividends on Stocks

Only stockholders of record are entitled to dividends, that is, only such stockholders as have had their stock registered in their own names will receive payment of dividends direct from the corporation which issues the stock. To meet this condition it is customary for the broker to transfer into his own name all stocks carried by him. For instance, a broker holding 500 shares of Steel common for various speculative accounts causes a transfer to be made which makes him the registered holder of 500 shares of common stock on the transfer and stock books of the United States Steel Corporation. The shares in this form are considered a good delivery. By good delivery is meant that the certificates bear the indorsement of a Stock Exchange firm, which makes them more readily acceptable in the Street than are stocks without such indorsements, and also that they comply with the Stock Exchange's rules for delivery.

Whenever a stock is about to sell ex-dividend, notice is printed on the ticker. All transactions in the stock are thenceforth made with the dividend "off." The price of such a stock frequently reflects a decrease to the extent of the dividend. For example, if Steel is selling ex-dividend John Jones can buy 100 shares at 99 instead of 100¼, but he is not given credit for the dividend when it is paid.

Customers carrying long stock before declaration of dividends, which are not disposed of before the time the stock sells ex-dividend, receive credit for the dividend on the day that it is payable. Thus, if a customer is long of 500 shares of Steel on which the quarterly dividend of 1¼% is declared and made payable, his account is eventually credited with $625, representing the quarterly dividend of 1¼%, or $1.25 per share. The cashier's department keeps a dividend memorandum book containing the names of customers entitled to dividend credits.

Any customer who is "short" at the time a stock sells ex-dividend is charged with an amount representing the dividend. The charge is equitable, for unless it is made the customer could cover his shorts at the lessened price of the ex-dividend stock and make a profit on the operation. The converse reason justifies crediting dividends to "long" customers. If the latter dispose of their holdings while the dividend is off, they lose on the transaction, but part of the loss is recovered through receiving credit for the amount of the declaration.

The broker's books may contain both long and short accounts in Steel. The credits on such longs and the charges against such shorts are made by journal entries through the supplementary journal or ex-clearing house blotter. For example, if Brown is long of 100 Steel and Jones is short of the same amount, Brown receives credit for $125, while Jones is charged with $125.

A question may be raised concerning the dividend on the 100 shares long. If the broker has this stock registered in his name, he receives any dividend paid on it while the stock is so registered. If, however, sales are made necessitating the delivery of these shares while the company's transfer books are still open, it is safe to say that the purchaser will make an immediate transfer of the stock and later receive the dividend. If the sale is made before the stock sells ex-dividend and no time remains for a transfer, the check is sent to the selling broker in whose name the shares are still registered. In this case, the latter gives the purchaser a due bill for the amount of the dividend.

Due Bills

The due bill mentioned above is a form of note in which the broker who will receive the dividend from the corporation promises to turn it over to the broker who is entitled to it. The delivery or receipt of a due bill is entered in a due

bill register. Each item in the register gives the name of the broker from whom payment is expected or to whom it is to be made, the description of the stock, the number of shares, and the amount of the dividend.

When stocks are borrowed against short sales of customers, they represent the long interests of the lending broker. If they are loaned before the ex-dividend period, the chances are that the certificates have been transferred to the names of some other brokers in the Street. Nevertheless, the lenders have a claim to any dividends declared on the stocks and look to the borrowers for the payment of these dividends. For the borrowers, on the other hand, such stocks represent customers' short commitments. Customers short of the stock are very frequently charged with the amount of the dividend as soon as it is declared, but this practice is questionable, since it permits the broker to charge interest on money he has not yet advanced. Besides, it is not altogether certain that the dividend will ever be paid.

All dividend stocks appearing in the securities ledger should be kept in sight, so that when notice of a dividend on any stock is received, the long and short accounts in that security may be segregated and the proper entries made in regard thereto.

Failure to Receive and Deliver

By the rules governing the delivery of securities as prescribed by the Stock Exchange all "regular" transactions are deliverable upon the next following business day, Saturdays excepted. It is the prerogative of the buyer to enforce delivery by making formal demand upon the seller. Failure to deliver thereafter gives the injured broker the right to "buy in under the rule," an operation which necessitates the repurchase by him of the securities in question. Any loss resulting from such repurchase is chargeable to the broker failing to deliver.

As an example, assume that broker A fails to deliver to broker B 100 shares of Sears Roebuck which the latter has purchased in the "regular" way from A at 95 per share. On the day following the failure to deliver notice is served upon A demanding delivery by 2:15 P.M. If the default continues, B notifies the Stock Exchange of the default and requests that the 100 shares of Sears Roebuck be "bought in" for the account of A. The securities thus purchased are paid for by B, the buyer, upon the same day. If the shares are purchased at 98, the loss sustained is chargeable to the defaulting broker. Prompt notice of the closing and a bill for damages must be served upon the broker in default. Buying in at 98 against A's original sale of 95 results in a loss of $300, which is set up in the ledger as though A were a customer who had made a short sale at 95 and covered at 98, thus suffering a loss of $3 per share.

In the general run of business this prerogative of the buyer is seldom exercised, as a certain comity exists among brokers whereby Failed to Deliver items are carried for a reasonable time until delivery is effected. Of course any abuse of the custom results in the closing referred to above.

Bookkeeping Treatment

The incomplete transactions resulting from failure to deliver require bookkeeping entries. Considering first the books of A, the sale of 100 shares at 95, or for $9,500, is credited to his customer and the corresponding debit entry is made to the Failed to Deliver account. On B's books the customer is charged with the purchase price of the shares, and the Failed to Receive account is credited as evidence of the liability due to broker A. The journalization in this case is made through the ex-clearing house or cash blotter.

Nor is the record complete after the foregoing blotter entries have been made. It is still necessary to record chrono-

logically all items which have not been received or delivered in the usual manner. These deferred items are listed in a "failure book" until such time as the contracts are completed. This book records on its right-hand or Failed to Receive page the date of the failures, the name of the brokers from whom due, the number of shares, the description of the stocks, the prices, the amounts involved, and the dates when the contracts are fulfilled. The left-hand, or Failed to Deliver page contains similar information except that it gives the names of the brokers to whom deliveries are due against sales.

When a final delivery is made by a seller an entry is made on his cash blotter, crediting the Failed to Deliver account and debiting Cash in the usual manner. Such an entry presupposes that the failed account is charged in the first instance. On the cash blotter of the broker to whom delivery is made the entry is a debit to Failed to Receive and a credit to Cash.

Alteration of Terms of Contract

Very often Failed to Deliver items are made the basis of stock loans, as where A becomes the borrower and B the lender of stock. While this appears to change the nature of the original contract, the duty to deliver the stock is nevertheless present. The reasoning behind this construction of the contract is as follows: Assume as before that A, the borrower, owes B 100 shares of Sears Roebuck at 95 on a contract of purchase and sale. B agrees to alter the obligation of A from a purchase and sale to a borrowing transaction, in which A owes B as a lender the 100 shares of Sears Roebuck at 95. This method is resorted to as a rule only where a rise in the market price of the shares in question makes it advantageous for B to suggest making a stock loan of the transaction. If Sears Roebuck advances to 120, B is in a position to compel A to keep the shares marked up to the market by paying the difference between the present market value and the original purchase price.

Frequently stocks which have been "failed upon" are rather difficult to borrow in the open market. If they could be borrowed a premuim would very likely have to be paid for their use. On that account brokers failing to deliver premium shares are compelled to pay the premium for the period of the failure, Saturdays, Sundays, and holidays excepted.

Bookkeeping Entries

In the transaction described in the preceding section the entry on B's books is a credit to Stocks Loaned in lieu of Failed to Receive, and on A's books the entry is a debit to the Stocks Borrowed account instead of Failed to Deliver.

Serious exception might be taken to thus changing one contract for another as described above if B's willingness to permit the change arises from a faulty conception of Stock Exchange procedure, under which B has a remedy for A's failure to deliver in the form of "buying in under the rule."

Other contracts of sale or purchase calling for deferred delivery or receipt of the securities in question are sometimes confounded with "failure" items. A seller's option contract calling for the delivery of 500 shares of Wabash common within thirty days does not require a charge to Failed to Deliver account and a credit to the customer, or on the purchasing broker's books, a charge to the customer and a credit to the Failed to Receive account. Such entries as these indicate a misunderstanding of accounting principles and of the terms of the original contract.

CHAPTER XV

CUSTOMERS' STATEMENTS AND ACCOUNTS

Purchase and Sales Memoranda

All transactions affecting customers' accounts result from the purchase and sale of securities. It is therefore logical that the purchase and sale invoices retained in the office of the broker should furnish the first posting media to the customers' accounts. It will be recalled that these invoices are copies of the original notice of purchase or sale sent to the customer. In the absence of the duplicate invoice system, the sources of the posting to customers' accounts, as previously stated, are the blotters—clearing house and ex-clearing house.

Monthly Statements

Pursuant to the law of agency, the broker owes his customer an accounting in connection with those transactions entered into by the broker for, and on behalf of, his principal. The charges comprehending the advances made by the broker, and the credits comprising the receipt of cash as a result of deposit, sale of securities, and dividend credit are made the subject of periodical report to the customer.

Thus it is the practice among brokers to render monthly statements to all customers. This statement is not to be confounded with the memorandum of purchase or sale which is sent to the customer after the execution of an order.

The ruling of the monthly statement provides for the date, explanation, amount, and total amount, also a column for the number of days for which interest is charged and a column for the amount of interest on each transaction. The debit and credit sides are similar in arrangement.

The account rendered, as transcribed from the ledger folio, may cover a series of long transactions subsequently offset through the sale of securities. In such a case the transcript is termed a "long account." Or the statement may contain a number of short commitments into which the customer has entered during the month, which may be counterbalanced by some subsequent purchases. In this instance the statement is called a "short account."

Whether the account is long or short, it should not contain a mixture of short and long transactions, because the mixed account does not reveal the true status of the customer's balance due to or from the broker. Hence, for purposes of accuracy, all short and long commitments should be stated separately.

Invariably, the broker, in rendering the monthly statement, brings down the debit balance due and lists the securities owned by the customer subject to that debit balance; or else the statement concludes with a credit balance subject to the cover value or the repurchase value of the securities of which the customer is short. A credit balance in a short account, therefore, does not represent the facts as accurately as does the debit in a long account, because it gives an incomplete statement of affairs which is completed only upon the repurchase by the customer or the delivery by him to the broker of the shares of which he is short.

Statements may contain facts of an affirmative nature also. That is to say, customers may be long of securities and yet have a credit balance on the books of the broker. Again, a customer, as this term is used in Wall Street, may be a creditor of the broker without having any commitment in securities.

Interest Charges

After the net interest to be charged or credited to a customer is arrived at, it is journalized through the supplementary journal and posted to the customer's account. From there it

is carried to the statement. At the top of the statement a space is provided for recording the interest rate at which the charges and credits have been figured.

The rendering of monthly statements involves two important operations: (1) the determination of the items on which interest is to be charged, and (2) the computation of interest.

These operations can best be illustrated by taking concrete cases. Let us take the account of John Jones, who on January 5 purchased on credit 100 Union Pacific at 125, or for $12,500, and sold the stock on January 12 at 126⅜, or for $12,637.50. This was a long account running for 7 days. It was a simple account for the reason that it contained no facts of opposite tendencies. If on January 13 Jones requests a check in settlement, the interest charge is determined that day. If the rate was 6% the interest would amount to $14.61, being the charge for 7 days at 6% on $12,520 (the purchase price of $12,500 and commission of $20). The interest period is obtained by taking the number of days between the date on which the Union Pacific stock purchase is charged and the date on which the proceeds of the sale are credited. Assuming that January 5 was Monday, the day of settlement would be the next day. As the date on which the proceeds were credited was the 13th, seven days is the interval for which interest is chargeable.

Interest charged against customers should be credited to an account known as "Interest on Customers' Accounts," although many brokers credit it to a general interest account. As customers are not usually in the habit of settling their accounts at irregular times, the lump sum of interest charges is usually credited at the close of each calendar month. This total amount of interest is the result of many different operations performed in connection with the customers' statements.

In discussing interest allowances to a customer, it is found that at times he is "long," while at other times he is either

"short" or "hedged," i. e., both long and short of different securities. If on his long stock he deposits margin, the account is entitled to a credit for the interest on this margin. Thus, if John Jones made a payment of $1,000 on January 6, he would be allowed 7 days' interest on this amount at 6%, or $1.17, and his credit balance on January 13 would amount to $1,080.06 (debits, $12,520 plus $14.61 interest; credits, $1,000 plus $12,613.50 plus $1.17 interest).

Suppose, further, that on January 18 Jones purchased 100 shares of Anaconda at 68, for which he was, of course, charged the next day. The time between the date of his deposit and the date of this charge covered a period of 6 days. During this time Jones's credit balance remained unchanged, and according to the custom which prevails he was allowed interest at the rate of 6% on his balance of $1,080.06. Then, if the Anaconda purchase was carried to the end of the month or longer, the bookkeeper computed and entered the interest against Jones up to January 31.

Interest is usually allowed on short accounts at the rate at which stocks are borrowed. Where a customer has a hedged account he is charged interest on his long commitments and allowed interest on his short transactions. This presupposes separate long and short accounts in the ledger.

One feature peculiar to short accounts must be mentioned here. The very large speculative accounts containing heavy "short" interests are a source of earnings to the broker from the interest received on borrowed stocks. It is quite conceivable that no personal outlay is made in the case of a short sale, for with the money which the broker receives against delivery he finances his borrowing operations. On this borrowed stock interest is earned which should be allowed to the customer.

Referring again to the account of John Jones (Form 11), the balance brought down under date of January 31 is a debit

John Jones Long a/c in account current with ADAMS, BURNS AND CONANT

interest @ 6%

DATE		AMOUNT		DAYS	INT.	DATE		AMOUNT		DAYS	INT.
1920						1920					
Jan. 6	100 Un Pac 125	12 520		25	52 17	Jan. 7	Cash	1 000 -		24	4 -
19	100 Anac 68	6 815		12	13 63	13	100 Un Pac 126 3/4	12 613 50		18	37 85
		19 335			65 80					Bal	41 85
31	Interest @ 6%	23 95				31	Balance	5 745 45		Int	23 95
		19 358 95			65 80			19 358 95			65 80
Jan. 31	Balance	5 745 45									
	Long securities viz:										
	100 Anaconda										

Form 11. Statement of Customer's Long Account

of $5,745.45. This debit balance is arrived at in the following manner: A charge in the account under the date of January 6 for $12,520, on which 25 days' interest is computed at 6%; a further charge on January 19 of $6,815, on which interest for 12 days is figured; a credit on January 7 of $1,000, on which 24 days' interest is allowed; and finally, a credit on January 13 of $12,613.50 ($12,637.50, minus $20 for commission, $2 for state tax and $2 for federal tax), on which 18 days' interest is computed. It will be noted that the computations are all made to January 31. The interest debits amount to $65.80 and the credits to $41.85, resulting in a net interest charge to John Jones of $23.95. Adding this sum to the total of $19,335 and deducting the total credits of $13,613.50 gives a net debit balance of $5,745.45, which is brought down on the statement. On the line below appears, "Long, 100 Anaconda." If John Jones did not trade again until March 1, 28 days of interest at the prevailing rate was charged on the debit balance at the end of February. Thus interest is compounded monthly.

Compounding of interest at the end of each month seems to be justifiable, from the fact that there is an implied understanding between customer and broker that all balances are due at the end of each month and that the rendering of a statement to the customer is to be construed as a formal demand for payment of the amount then due. If the customer does not make payment, the balance brought forward into the succeeding month becomes the new principal on which interest is calculated. To prevent the compounding of interest the customer should pay the current interest charges, thus permitting the loan or advance to remain at the original figure.

The same method of balancing the customers' accounts obtains in the case of short accounts, but the balance brought down appears on the credit side and a list of the short stocks is given.

Interest Rates

As already explained, the broker advances the difference between the purchase price of securities and the amount of margins deposited by his customers, and on this loan he charges interest. As interest rates vary, the rate to be charged needs careful determination. The rules of the Stock Exchange provide that "any agreement or arrangement entered into between a member or his firm, and his or their customer, whereby a special and unusual rate of interest is stipulated for, or money advances upon unusual terms are made a condition, in connection with the conducting of an account, with intent thereby to give special or unusual advantages to such customer for the purpose of securing his business, shall be deemed to be a violation of Art. XXXIV of the constitution, commonly known as the Commission Law." Allowing a rate below what money costs the broker is regarded as a violation of this provision. Hence the importance of a careful computation.

Method of Computing Interest

In computing the interest, first the broker's capital is considered and on it a rate of 6% is allowed.

Second, huge sums are borrowed from banks on call loans at rates of interest which fluctuate daily. If the average amount borrowed on call is $10,000,000, and the average interest rate paid is 6.35% during the month, that rate enters into the determination of the rate to be charged to customers.

Third, the broker borrows on time loans. The rate on these loans may be 6%, plus 2½% for commission, or 8½%. This rate is taken into consideration with the two rates mentioned above.

Fourth, the interest paid on stock loans is averaged.

The total of the principal borrowed and that owned, figured at the average rates, provides the basis for the interest charged to clients.

Owned Capital	$2,000,000	6%
Average Borrowed Call	10,000,000	6.35%[1]
" " Time.......	1,000,000	8½%
Stocks Loaned	3,500,000	5.86%[1]
Total Capital	$16,500,000	

The average interest, paid on an annual basis, is $1,045,100, which is equal to 6.3333% on $16,500,000.

Knowing the cost of his money, the broker usually adds a fraction of a per cent to what the basic rate approximates. Of course this excess is "secondary income" to the business and very often pays the running expenses of the office.

Relation Between Accounts and Statements

The ledger account and the monthly statement sent to the customer must agree in every particular, which means that the long stocks carried down together with the balance must agree with the statement.

Sundry Debits and Credits

Since the customer owns the securities which he purchases, subject of course to his debit balance, all increments, whatever their nature, are credited to the customer. Consequently, cash dividends declared by a corporation whose stock is thus owned by the customer must be credited to the customer's account on the date the dividend is payable. Similarly, the customer is entitled to credit for any premiums the broker receives in lending stocks to other brokers.

A nice question arises when stocks in which the customer is long are lending at a premium because of a scarcity of such shares in the loan crowd. The broker who lends the shares not only receives free of interest an advance for their market value, but in addition receives the premium. If the broker pays no

[1] As a result of daily averages.

interest for the use of these funds, shall the customer nevertheless pay interest to the broker? The answer must be made in the negative.

To carry the hypothetical transaction further, let it be assumed that A, B, C, and D are each long 100 shares of a premium stock and that the broker is able to lend only 100 shares of it at a premium. The premium received should be prorated equitably among the four customers, and each should be charged interest on only three-fourths of the amount involved in the purchase of the stock. While in practice this apportionment is seldom made, it should nevertheless be done, in fairness to customers. Nor is the purchase cost of the respective holdings split up into two parts, one subject to interest and the other not so subject. It is customary to lend a particular customer's stock at a premium, although this practice works to the prejudice of all other holders of the stock, but it is followed in order to facilitate bookkeeping.

Corporations sometimes declare stock dividends in lieu of making cash disbursements. They also on occasion issue "rights" to subscribe to additional shares. These facts must be evidenced by proper entries on the broker's books, if customers carry any of the old stock. Those who are entitled to the new shares or the rights to subscribe to new shares should be advised formally by the broker. The receipt of these values is recorded on the debit side of the customers' accounts, and the entries are to be interpreted as denoting the receipt of stock or rights free of all money charges against the customer. The reason for the debit entries becomes obvious when it is recalled that an account is debited with the receipt of shares, whether or not cash has been paid, and is credited with the delivery of shares, whether or not cash has been received.

To illustrate this point, assume that on January 5 John Brown purchased 100 shares of United States Rubber for $12,615, and that subsequently a stock dividend was declared

by the corporation. Accordingly, John Brown's account then showed that, let us say, 5 shares of stock had been received in the form of a dividend which cost Brown nothing. On the same day his account was debited with 5 shares of United States Rubber, for which no money was paid. Therefore there was no money charge against him. The account showed 105 shares of Rubber long against the same debit balance of $12,615.

Owing to the reorganization of companies from time to time, stockholders are assessed certain sums of money in order that they may obtain new shares of the reorganized concern. Such assessments are paid by the broker for the "long" customer's account and are therefore logically charged to the customer.

Where an account is short of securities and a stock dividend or rights are declared by a corporation, the person so "short" becomes additionally short of the new shares or rights. When the customer covers or repurchases against his short commitments, he not only buys back his original shortage, but also the number of shares of which he is short by reason of the stock dividend declaration, or rights in case the company has issued them.

Where cash dividends are declared, the amount of such dividend is charged to the short account when paid by the corporation.

When an account is short of stocks which lend at a premium, no interest is allowed on the short sales, but instead, the premium is charged to the customer until he buys back or until the premium charge is discontinued in the loan crowd.

The recording of assessments on short stocks is easily understood if it is remembered that a long account is charged with such assessment. The person "short" is credited whenever his commitment is in those shares upon which an assessment has been levied by the corporation. Since he is short of

a stock inferior to that created by means of adding the assessment value, and since he is compelled to buy back or cover the newly assessed stock, he must be compensated by being credited with the assessment, so that his financial position will not be altered.

CHAPTER XVI

CLOSING THE BOOKS

Income

Income in a brokerage business is derived from:

Commissions
Interest on customers' accounts
Interest on stocks borrowed
Premiums (unless distributed to customers)

Expense

The expense items in a brokerage business may be divided into general expense and solicitors' expense.

General expense embraces the following:

Rent
Office salaries
Telephone
Telegraph
Cable
Ticker service
Stationery
Printing
Postage
Stock Exchange dues
"Floor" brokers' commissions
Clearing house fees
Purchase of manuals
Market reports
Financial systems
Advertising (in periodicals and trade journals)

Solicitors' expense includes:

Salaries of solicitors or agents
Traveling expenses

Very often, in the conduct of branch offices, the keeping of separate income and expense accounts is required in order to measure the productivity of business coming from such offices.

Omitted Expenses

One important consideration in closing the books of a brokerage concern is the accounting for certain liabilities not usually evidenced by the books. The care generally exercised in accounting in other businesses does not characterize the accounting in a broker's office, where no scientific methods are followed in connection with the peculiar accounting system employed. Often the broker does not enter at all the many invoices which he receives for miscellaneous services and supplies, such as stationery, printing, telephone, telegraph service, and the like; nor is he apt to give attention to accrued interest payable, salaries, or rent. On that account the great majority of financial statements prepared by brokers contain nothing but cash factors. This practice is wrong and is badly in need of correction.

The broker is engaged in business for the purpose of making a fair return on his capital. It is of interest and of value to him to know the cost incidental to the purchase or sale of each 100 shares of stock, what the volume of business has been, and how much profit has been made during the year. Such information, if available to the administrative head of a business, determines his future business policy, thus making for efficiency and increased profits. For this reason special attention is given here to the items of cost referred to above, which are so frequently neglected in the brokerage business.

Accruals

Many concerns overlook the importance of accruals because the business, for the most part, is conducted strictly on a cash basis. This, however, does not justify their omission, for despite all statements to the contrary, the true condition of any concern cannot be determined without the application of correct accounting principles, and these require the proper consideration of accruals when the books are to be closed.

Accrued interest on interest-bearing notes receivable should also be shown in the profits for the period. The same rule should govern in the case of interest from stocks borrowed and money loaned.

In connection with the income items it might be added that all accrued interest on bonds owned should be brought into the income statement. The interest on customers' accounts should also be given proper consideration.

Liability accounts should be set up for accrued salaries. Rent and interest on stocks loaned and money borrowed should be treated in a similar manner. Interest on any notes payable which the broker may have outstanding should also be included.

Reserve Accounts

Usually the capital contribution of a brokerage concern includes securities whose value changes during the accounting period. If the securities have risen in value, conservative practice does not permit the writing up of the asset for the purpose of increasing the earnings. If, on the other hand, the value has depreciated, ample provision should be made for such depreciation, the usual reserve account being credited for the purpose.

Reserves should also be set up for the estimated amount owing to sundry creditors and for traveling expenses of solicitors on the road. Too often the bills which should have

found expression on the books as audited vouchers unpaid are allowed to burden the next accounting period.

As the broker on the floor of the Exchange might have had occasion to distribute some of his business to "floor" specialists, the commissions payable to the latter should not be overlooked. The books should show very plainly whether any business has been so distributed, and if such distribution is shown, ample provision should be made in an account called "Floor Brokerage Commission Payable."

The Income Statement

1. *Income from Operation.* In a brokerage business the most important source of income is the commissions received from customers. The broker enters the business with the primary purpose of earning such commissions. Hence, the commission item practically measures the amount of money he makes in operating. An independent commission account may well be set up, if for no other reason than statistical purposes.

All other items of income, as interest on customers' accounts, premiums, etc., are brought in under heading 5, "Secondary Income."

2. *General and Administrative Expenses.* This section should contain all expenses incident to the operation of the business, save solicitors' and branch office expenses.

3. *Solicitors' and Branch Office Expenses.* Solicitors' expenses and those incidental to the conduct of branch offices are usually kept under separate and distinct accounts for statistical purposes. The items usually included in these accounts are:

Rent of branch office or offices
Salaries of branch office managers and clerks
Advertising of branch office
News ticker service
Traveling expense of solicitors

The expense items under headings 2 and 3 represent all the expense usually incident to the general operation of the business and they might properly be grouped under the one caption, "Total Expense."

4. *Net Income from Operations.* This is the resultant figure arrived at by deducting "Total Expense" from "Income from Operations."

5. *Secondary Income.* Under this heading should be listed interest earned in financing customers' transactions. The usual items of secondary income are:

Interest on customers' accounts
Interest on notes receivable
Interest on stocks borrowed
Premiums on stocks loaned, if not distributed to customers
Interest earned on bonds held as investment
Dividends on stocks held as investment

6. *Deductions from Income.* This heading embraces such items as:

Interest on stock loans (equivalent to borrowed money)
Interest on money borrowed
Interest on notes payable

Premiums on stocks borrowed are chargeable to the customers who are short of such stock.

7. *Net Income from All Sources.* The difference between "Secondary Income" and "Deductions from Income" shows the addition to, or deduction from, "Net Income from Operations" and gives the total net income from all sources.

8. *Profit and Loss Charges.* These charges should include a reserve provision for doubtful accounts receivable, whereever such accounts exist; a reserve provision for depreciation of furniture and fixtures, which is an important item in large

banking offices; a reserve provision for expenses in connection with the business in general; and provision for any loss incurred on the sale of securities which have been held for investment.

9. *Distribution of Profit.* The distribution of any remaining profit should be the last item included in the income statement.

The Balance Sheet

The arrangement of the assets and liabilities on the balance sheet of a brokerage house (Form 12a) does not differ from the arrangement usually employed by accountants. There are items, however, in the broker's balance sheet which cannot be as easily read as items in the ordinary commercial balance sheet. Some items present apparent contradiction in that they do not take into account the equity or margins in customers' accounts or in the collateral loans of the broker.

Assets. The asset side of the balance sheet is subdivided into:

1. Capital Assets
2. Current Assets
3. Deferred Debits to Income

Under the first heading, "Capital Assets," appear such items as Exchange seats, and furniture and fixtures.

Among the capital assets of the stock-broker who clears his contracts through the clearing corporation, is the amount deposited as a guarantee fund with the New York Stock Exchange Clearing Corporation.

The second heading, "Current Assets," embraces cash, accounts receivable, investments, notes receivable, stocks borrowed, and all accrued interest items. The accounts receivable recite no definite financial ruth unless read in connection with the table of equities, explained below.

ASSETS	$		$	
Capital Assets:				
Stock Exchange Seat	75,000	–		
Furniture and Fixtures	25,000	–	100,000	–
Current Assets:				
Investments	$ 190,000	–		
Accounts-Receivable	104,280	–		
Stocks Borrowed	52,000	–		
Accrued Int. Stocks Borrowed	104	–		
Cash-Manhattan Company	72,108	30		
Total			418,492	30
			$ 518,492	30

LIABILITIES AND CAPITAL	$		$	
Current Liabilities:				
Money Borrowed	50,000	–		
Stocks Loaned	51,000	–		
Int. Accrued-Stocks Loaned	25	50		
Accounts-Payable	58,015	–		
Total			159,040	50
Capital:				
A. Adams	$ 152,830	28		
B. Burns	103,281	27		
C. Conant	103,340	25		
Total			359,451	80
			$ 518,492	30

Form 12. (a) Balance Sheet—Adams, Burns and Conant—December 31, 1920

A third subdivision of assets, "Deferred Debits to Income," may include such items as rent paid in advance, advertising paid in advance, Stock Exchange dues paid in advance, and all similar items which have to be analyzed for the purpose of determining the portion applicable to the accounting period just closing.

Liabilities. All liabilities are current in nature. There are no deferred credit items nor capital liabilities. Stock loans, accounts payable, which usually are deposit accounts or open credit accounts, interest and salary accruals, all appear under the single caption of "Current Liabilities."

Proprietors' Accounts. The proprietorship section of the balance sheet, comprising reserves and partners' capital accounts, is self-explanatory.

Table of Equities or Liquidating Balance Sheet

The table of equities (Form 12b), sometimes referred to as the "liquidating balance sheet," "equity statement," or "statement of margins," is a most important supplement to the balance sheet. Its purpose is to present the status of each account into which the question of margin in favor of or against the customer may enter.

The significance of the equity statement can be made clear by means of the following transaction: Suppose an account is long of 5,000 Steel at 100, the purchase price, and that the present market price is 95. How does this affect the balance sheet? The ledger balance in this case shows approximately a debit of $500,000, the securities appearing as 5,000 Steel. It is obvious that this does not reflect the true condition of the account; but as all the stock accounts receivable are grouped together in the balance sheet, it is practically impossible to segregate any particular account from the mass. From the broker's point of view the statement of the account is correct, as the stock accounts receivable are considered abso-

NAME OF ACCOUNT	NO. OF SHARES LONG	NO. OF SHARES SHORT	DESCRIPTION	MARKET PRICE
Stock Exchange Seat				
Furniture & Fixtures				
Investments:				
(List Longs:-)				
Accounts Receivable:				
John Jones	1000 ✓		Steel	102
Fred Smith	50 ✓		Un. Pac.	126
	50 ✓		R.B.C.	110
R. Berg				
Stocks Borrowed:				
A. A. Holmes & Co.	500 ✓		Stude	104
Accrued Interest:				
A. A. Holmes & Co.				
Cash:				
Manhattan Co.				
Money Borrowed:				
Chase Natl Bank	500 ✓		Steel	102
	50 ✓		Un. Pac.	126
	50 ✓		R.B.C.	110
Stocks Loaned:				
A. Liffer & Co.	500 ✓		Steel	102
Interest Accrued Stocks Loaned:				
A. Liffer & Co.				
Accounts Payable:				
A. Adams Spl. "Shorts"		500 ✓	Stude	104
F. Robinson				
A. Adams c/a				
B. Burns c/a				
C. Conant c/a				

Form 12. (b) Table of Equities or Liqui-

MARKET VALUE				LEDGER BALANCES				LIQUIDATING VALUES			
DR. SHORT		CR. LONG		DEBIT		CREDIT		ASSETS		LIABILITIES	
		$75,000		$75,000				$75,000			
		25,000		25,000				25,000			
		190,000		190,000				190,000			
		102,000		92,000						$10,000	
		6,300		10,800							
		5,500								1,000	
		1,480		1,480				1,480			
		52,000		52,000							
		104		104				104			
		72,108	30	72,108	30			72,108	30		
				$518,492	30						
		51,000									
		6,300									
		5,500				$50,000		12,800			
		51,000				51,000					
		25	50			25	50			25	50
$52,000						56,905				4,905	
						1,110				1,110	
						152,830	28			152,830	28
						103,281	27			103,281	27
						103,340	25			103,340	25
						$518,492	30	$376,492	30	$376,492	30

dating Balance Sheet, December 31, 1920

lutely good. The cashier of a bank, however, who had occasion to review the balance sheet would not so consider it, as in such form it is confusing and even misleading. This deficiency is supplied by the table of equities, which discloses the true condition of every real account carried on the books of the broker, including the steel transaction considered above in which the table of equities discloses a decrease of $25,000 in asset values.

The arrangement of the table of equities is such as to show in each case the name of the account receivable; the number of shares long and short; the description; the market price and market value; the ledger balance, debit or credit; and the liquidating value of assets and liabilities. If it is an open credit account, the ledger credit and the liability are the same. If it is an open debit, considered perfectly collectible, the amount appearing in the ledger debit column appears again in the asset column.

By this "refining" process the accounts receivable as represented on the balance sheet and as shown on the equity statement, are contrasted as to money values. This is done by footing the two margin columns, the difference between the debit and credit sides representing the equity due to customers or due to the house from the customers.

Every account is treated on this statement in such a way that the ledger columns really present the balance sheet accounts, while the last columns indicate the liquidating values or equities of each individual asset and liability account.

Combination Equity Statement and Balance Sheet

Very often, instead of the standard form of balance sheet, a combination of the equity statement and balance sheet is employed. On such a combination statement the facts and figures are thrown into contrast, and the result is a true presentation of the broker's affairs.

In the preparation of this combined sheet it may be said in brief that, as each balance is struck in the ledger, the amount of equity which the broker or the customer retains in the asset or liability is listed. For example, in his cash account the broker has 100% equity. In a stock account receivable, only the customer's equity is shown.

The amount of margin which a broker retains in collateral loans is shown as an asset under liquidating values.

Applying Market Prices to Total Longs and Shorts

Accountants also use other devices in determining the financial status of their client's affairs. Not infrequently they apply the market values of all long securities against the sum total of the customers' long accounts, the resulting difference representing the equity to which the customers are entitled if they liquidate their commitments at the market prices used in the compilation. They likewise deduct the total market values of all "short" contracts from the total credit balances of all "short" customers, the difference reflecting the amount which would be due to the clients should they liquidate their "short" contracts at the market prices used.

The difference between this method of computation and the one previously explained lies in the fact that market prices are applied to groups instead of to individual items.

CHAPTER XVII

LIQUIDATION AND DISSOLUTION

Liquidating Balance Sheet

Since the broker is engaged in a business of which the assets for the most part are current or liquid, it becomes a very simple task for him to strike off a liquidating balance sheet. In substance, this financial statement can be compared to the statement of realization and liquidation compiled for a concern which is winding up its affairs. However, in brokerage the broker merely determines the financial status of his business by applying the market price of securities against those which he is carrying for customers, "long" or "short." In preparing this form of balance sheet he proceeds upon the assumption that his customers' holdings are to be liquidated, so that their equities represent his actual liabilities. From such assumed liquidation the natural inference is that the broker in turn must also liquidate his liabilities through the payment of his stock and bank loans, as well as the realization upon his Stocks Borrowed and his Money Loaned accounts. If there are any such loans, the result of this assumed liquidation reveals the exact condition of affairs as of a given date. The residuum is in the form of cash, and this should equal the broker's original investment plus profits realized, or less losses sustained through operations.

Such a form of balance sheet is somewhat confusing to the average reader, unless a footnote is added to the effect that the compilation is merely a tentative liquidation of the business.

It is believed that the statement of equities or liquidating balance sheet gives a clearer presentation of affairs than the ordinary balance sheet, since by it the relation of the liquidating values to the unliquidated commitments is revealed. It

acts as a very excellent guide to the broker or his banker in measuring the broker's skill in managing his business.

Legal Aspects of Insolvency

The accountant's services are usually availed of by brokers only in times of financial stress. This practice is to be condemned, since the task of determining the solvency of a broker's business is comparatively a very simple one and the investigation should be made regularly for the protection of the broker as well as his customers. The broker's business logically calls for periodic audits by competent accountants in order to determine its financial condition, since there is a legal penalty imposed upon brokers for accepting funds when they are aware of their insolvency. The Penal Law, Section 955, added by Chapter 500 of the Laws of 1913, provides substantially that a stock-broker who, knowing that he is insolvent, accepts money or securities from a customer who is ignorant of his insolvency and thereby causes the customer to lose such money or securities, in whole or in part, is guilty of a felony; and that he shall be deemed insolvent whenever the aggregate of his property is insufficient to pay his debts.

Method of Determining Solvency

A very simple device for determining the status of a broker's business is to determine first the amounts due to customers, i.e., their equities in the running speculative accounts. This, together with the absolute accounts payable, furnishes the total liabilities of the broker as evidenced by the books. Then, as against these liabilities, the quick assets could be set up very rapidly in the following order:

1. The equities which the broker has in collateral loans.
2. The equity he has in stocks borrowed and stocks loaned which have not been marked to the market price.
3. The cash in banks and on hand.

4. The market value of his investment accounts.
5. The market value of the securities unpledged, carried on margin for customers; in other words, the value of the broker's "box."
6. The value of securities in transfer offices to be registered in the broker's name.
7. The value of Exchange membership.

Deducting the liabilities from the sum total of the above list of assets gives the financial condition of the business.

As a general rule a statement containing the items indicated above should be prepared monthly. In preparing this statement, any material defalcation by clerks, or losses incurred, could be sensed and brought to the attention of the administrative partner.

Voluntary Dissolution

Brokerage houses are usually partnerships, and their voluntary dissolution is easily accomplished by the mutual consent of the partners.

Under the law of partnership dissolution may also be brought about in the following ways:

1. The expiration of the term as stated in the articles of copartnership.
2. The death of a partner.
3. The insanity of a partner.
4. The assignment of a partnership interest to a third person.
5. An action in Equity for dissolution of the partnership.

Very often Wall Street enters upon a period of depression, and usually before the depression ends a number of brokerage firms tire of the inactivity and go into voluntary dissolution, especially as rents are high and other business expenses are heavy. In event of such dissolution, the customers are noti-

fied of the firm's intention to discontinue, and a request is made for the settlement of all open accounts. This is made possible by either "taking up" the accounts or transferring them to some other broker. The assets remaining are distributed among the partners, and the business is dissolved.

Involuntary Dissolution

Involuntary or forced dissolution, on the other hand, is far more troublesome. Sometimes this condition is an outgrowth of untoward developments, such as panics or business depressions. In most instances, however, it arises through speculation on the part of the firm itself, which endangers its clients' funds, or an inefficient margin department.

If insolvency or bankruptcy does not result directly from such speculations, the Stock Exchange intervenes in the "private operations" of the firm, and expulsion or suspension results. What is more, the offenders are liable to their customers in legal actions for conversion.

Release of Securities Held by Bankrupt Firm

When bankruptcy proceedings are instituted against a brokerage firm, several nice legal questions arise, the essence of which is the status of the customers as creditors of the firm and the relation of other brokers to the bankrupt.

When a brokerage firm assigns, the most important question to be answered, and one which no doubt concerns the customer most, is how he can "lift" the account, that is, release the equity in his securities. There are several cases in law which cover this point. In the matter of Meadows, Williams and Company [1] it was held that where the identical certificates of stocks or other evidences of ownership purchased in execution of a customer's order are traceable, he

[1] 177 Fed. 1004.

can, by payment of his debit balance, have his securities released to him. On the other hand, if the securities have not been pledged but are carried by the broker, the customer may succeed in enforcing his claim to them, even though it is impossible to establish the identity of the certificates.

It was also held in this case that wherever the securities carried by the broker represent the holdings of several customers in the same stock, even though the certificates cannot be identified, each customer has a just claim to his pro rata share upon payment of an amount sufficient to release the securities. Also, if at the time of failure the broker has in his possession all the securities represented by customers' accounts, each customer may release his equity by paying the amount of his book balance to the assignee or trustee in bankruptcy.

In the case of Chamberlain v. Greenleaf,[2] it was held that if the securities are pledged to a third party to secure a loan to the bankrupt, and these securities are distinct and separate from all other securities, the customer may release his equity upon payment to the pledgee of the amount secured by such stock and also upon payment of any differences in the account to the legal representative of the bankrupt.

In the case of Gould v. Central Trust Company,[3] it was held that when customers' securities have been mingled in one bulk and pledged, the customers can release their holdings by paying their pro rata shares, so that the total will equal the amount covered by the pledge, and any differences are to be paid to the estate of the bankrupt. The court further ruled that if a part of the securities have been sold in satisfaction of a prior lien of the pledgee, the balance of the securities may be disposed of and the funds realized therefrom distributed on a pro rata basis among the various customers whose securities make up the loan, without the necessity of first determining

[2] 4 Abb. N. C. (N. Y.) 178.
[3] 6 Abb. N. C. (N. Y.) 381.

which set of customers owned the particular securities that were sold in satisfaction of the lien.

Of course, the principles of equity as well as the doctrine of marshaling in the case of bankruptcy require that to satisfy a lien the broker's securities, which together with the customers' securities constitute the collateral in a loan, be first disposed of before any of the customers' shares are sold.

Customer's Equity in Deposited Securities

In the matter of Mills,[4] a situation arose where a customer deposited with his broker securities as margin on a running account. These securities were pledged in order to raise funds, and in an action brought later it was contended that such stocks and bonds had no priority over securities that were purchased originally on margin. The court ruled that there was no distinction between securities deposited as margin and securities purchased and carried on margin.

It would appear, however, that if the securities are deposited for safe-keeping and are pledged without the knowledge or consent of the owner, such owner can insist upon the sale of securities bought on margin before any disposition is made of his holdings. If his securities are sold before others, he can demand the disposition of the remaining securities in order that restitution be made to him to cover the fair value of his stocks or bonds.

If there is evidence of a collusion existing between the pledger and the pledgee, and the securities owned by an innocent third party are sold to satisfy a lien, the courts would support this third party in his claim to recover full value.

Equity in Clearance Loans

In the case of the Mechanics National Bank v. Ernst, it was decided by the United States Supreme Court, November 3,

[4] 125 App. Div. (N. Y.) 730; 193 N. Y. 626 (1908).

1913, that clearance loans carry with them no superior equities in securities trusteed in connection with such loans. It was ruled that the bank was only a general creditor and was entitled to share as such.

Generally speaking, the National Bankruptcy Act governs almost exclusively in all actions for the recovery of securities when the broker has been adjudicated a bankrupt.

Disposal of Broker's Stock Exchange Seat

In regard to the bankrupt broker's membership on the Exchange, Sections 1 and 3 of Article XVI of the constitution of the New York Stock Exchange provide as follows:

> A member who fails to comply with his contracts or is insolvent, or who is a partner in a firm registered upon the Exchange which fails to comply with its contracts or is insolvent, shall immediately notify the President, in writing, that he or his firm is unable to meet their engagements, or prompt notice thereof shall be given to the Exchange. He shall thereby become suspended from membership until, after having settled with his creditors or the creditors of his firm, he has been reinstated by the Committee on Admissions. If a member suspended under this article fails to settle with his creditors and applies for reinstatement within one year from the time of his suspension, his membership shall be disposed of by the Committee on Admissions.

Before the customers may share in the funds realized from the sale of the broker's Exchange seat, all the claims of other members of the Exchange have first to be paid. Any surplus remaining is distributable among the respective creditors of the firm and of the partners individually.

In concluding it may be said that there are many other features and conditions of the broker's bankruptcy which are too technical for discussion here. Only a few cases have been cited to illustrate the more important phases of the question and

to indicate the status of customers in the capacity of creditors. Almost daily problems are met in which a knowledge of the law is invaluable to the accountant whose duty it is to ascertain the equities of customers of a defunct brokerage concern.[5]

---

[5] The legal information given here has been epitomized from Douglas Campbell's "The Law of Stock Brokers."

PART II

COTTON BROKERAGE

CHAPTER XVIII

THE COTTON FUTURES MARKET

The Market

The cotton futures market plays an important rôle in the disposition of the annual cotton crop. It is the medium for distributing approximately 15,000,000 bales yearly, which, resolved into terms of money, gives $1,050,000,000, figuring the average price of cotton at 14 cents per pound. The system of "futures" facilitates the movement of cotton from grower to consumer.

Cotton brokers are engaged in trading for either "spot" delivery or "future" delivery. The former involves but very little accounting, and is treated in Chapter XXII. The accounting requirements of the futures market are, on the other hand, peculiar and rather intricate in nature.

Expressed briefly, the futures market is a system of trading in cotton options, the commodity not being deliverable until the time specified in the contract. The active issues or options traded in are those of January, March, May, July, August, October, and December. An option for any of these months may be traded in up to the last "tender day," or "notice day," of the preceding month, which is the time set by the Cotton Exchange for the expiration of the options for the next month and the ceasing of trading in the commitments. For example, January cotton may be bought or sold up to the last tender day in the preceding December, or May cotton may be traded in up to the last tender day in the preceding April.

When January, 1920, cotton was purchased in 1919, the commodity was tendered on or about December 30, 1919, and

the purchaser was called upon at that time to make payment against the delivery to him of a warehouse receipt. On the other hand, if the buyer wished to dispose of his holdings of January cotton, he could do so at any time until the last tender day.

Most of the buying and selling of cotton futures is for speculative purposes. The customer does not wish to buy or sell actual cotton, and when his commitment falls due settlement must be made in some other way than by the actual receipt or delivery of cotton, and this is done on or before the last tender day.

A customer having a long interest in the market usually sells his cotton for the outgoing month, and if he wishes to retain a long interest, purchases futures for succeeding months. For example, assume that John Jones is long of March. Being compelled to sell out his longs in the last days of February, he sells March cotton to satisfy his March contract and buys May cotton to retain his long interest in the market. Or suppose that John Brown is short of March. Being compelled to buy in by reason of the approaching expiration of his contract, he buys March and sells May, thereby retaining his short interest. In these cases it is taken for granted that Brown does not intend delivering, and that Jones does not contemplate receiving cotton. They are therefore compelled to settle their contracts by purchase and sale of the maturing options respectively.

Cotton mills which sell a good deal of their output on contract at a certain price use the futures market for hedging purposes, that is, as an insurance against a rise in the price of raw cotton. If the price rises after a mill sells its product but before the goods are manufactured, or the raw cotton purchased, the mill loses to the extent of the advance. To prevent such loss or advance sales cotton mills usually hedge by purchasing a sufficient number of bales of futures, and thus

protect themselves against any increase in the price of the raw material. If the price of cotton should subsequently rise, the loss incurred by reason of the increased price of the raw material is offset by the profit made on the cotton bought on futures. If, on the other hand, the price of raw cotton falls before its actual purchase, the additional profit which this gives on the manufactured product offsets the loss on the futures. Thus the futures purchase serves the purpose of stabilizing cost, or insuring against loss. Spot cotton dealers use the futures market in much the same manner.

An additional function which the futures market performs is the maintenance of a ready market for cotton. Its prices are based on the effective demand for and the real supply of "classified raw" cotton. It eliminates the very wide and arbitrary fluctuations of prices that would otherwise occur.

Customs of the Futures Market

According to the rules set down by the New York Cotton Exchange, cotton is traded in for future delivery in quantities of not less than 100 bales, each 100 bales, in technical terms, constituting "one contract." On this basis 1,000 bales of cotton are equivalent to 10 contracts. Furthermore, the Exchange has specified the weight of 50,000 pounds as a contract, each bale weighing 500 pounds. The price of cotton is quoted in terms of cents and hundredths of a cent per pound. One cent on 100 bales is equivalent to $500, and one one-hundredth of a cent, which is known as a point, is equivalent to $5.

The only cash transactions in the cotton market are those in spot cotton. All other transactions are settled by means of the "differences" system, which has as its chief feature a cash payment, or receipt, for the difference between the price paid for the cotton and the price received on the sale. Thus, if a customer purchases 100 bales of cotton at 13.08 cents per pound and sells it at 13.20 cents per pound, he gains the differ-

ence of 12 points, or $60, as a result of the deal. Figuring this by the ordinary method of calculation, the contract of 50,000 pounds at 13.08 cents per pound costs $6,540, and at 13.20 cents it will yield $6,600, or a profit of $60.

Books of Account

Two distinct sets of books are kept by the cotton broker, one dealing with customers' transactions, and the other with the same transactions from the clearing house end, i.e., with the cotton broker's dealings with other brokers. Only by a system of interlocking the two sets of books is a check upon the clearing house books made possible. Reference to this point will be made later (Chapter XXI).

The Customers Records

The books used for the record of transactions with customers are as follows:

Purchases and sales book
Customers margin book
Customers contract book
Customers ledger
General journal
General ledger
Cash book
Account sales register, or contract analysis journal

Purchases and Sales Book

The ruling and arrangement of the purchases and sales book does not vary in any material respect from the similar book used in the stock brokerage business. The headings of the columns are practically the same, the only difference being that the caption "Number of Bales" appears instead of "Number of Shares."

Customers Margin Book

The principles underlying the system of margins in the cotton market are the same as in the stock market, so that the same card system or loose-leaf device can be installed with good results. Other forms used by stock-brokers are also employed.

Two hundred points, or $1,000, is considered a safe margin on one contract, although the amount is changed from time to time. Conservative brokerage concerns call for additional margin when one-half of the existing margin is consumed by paper losses as a result of an adverse movement in the market price. For instance, if John Brown, a customer, purchases 100 January at 13.08 and the price declines 11 points, or $55, this potential or paper loss is subtracted from the margin which Brown has deposited on account of his purchase. Assuming that he has had originally a ledger credit of $1,000, his margin is now $945, or 189 points, which is still sufficient to carry the account. If, however, the price for January should decline to 12.08, Brown would be called upon for $500 additional margin. If he should fail to respond after a reasonable time, the length of which depends altogether upon the condition of the market, an order would be entered to sell 100 January at about 11.15 on "stop," which means that if the price of Janaury fell to 11.15 the order would be executed at that price. Having purchased the contract at 13.08 and sold it at 11.15, Brown's loss would be 193 points, or $965.

It should be noted here that an entire contract comprises both the purchase and sale of a commitment.

Customers Contract Book

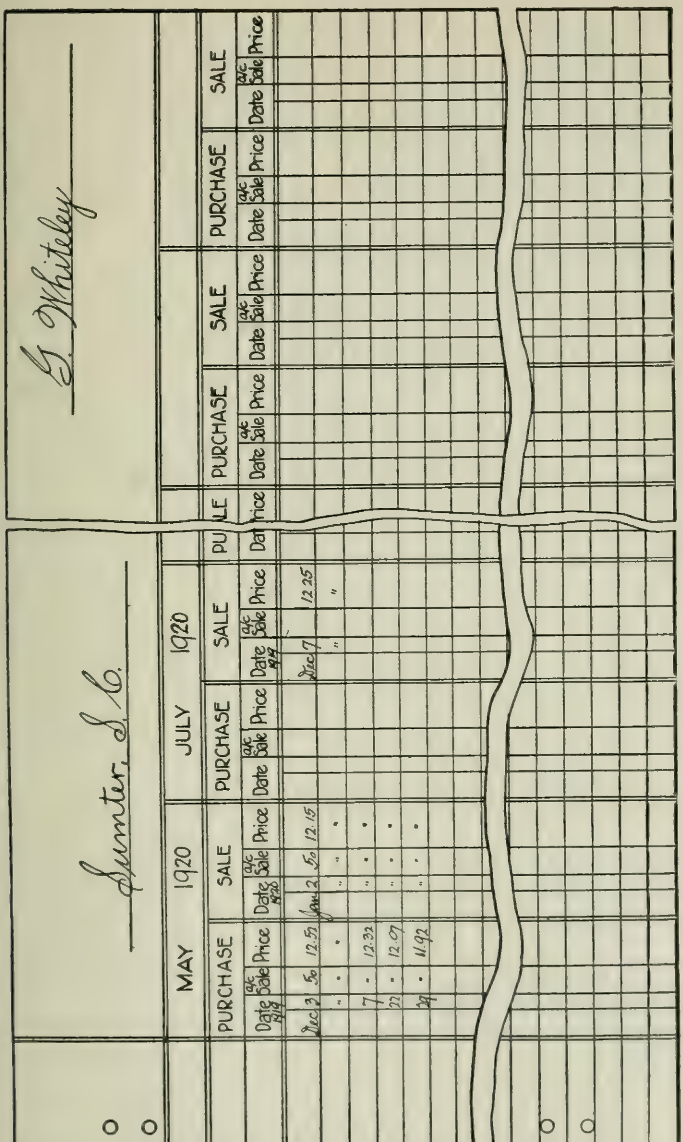
Form 13 shows a sheet from the customers contract book. Entries are made in this book from the purchases and sales book. Each customer has one page allotted to him, and the

ruling provides for the classification of the options bought and sold, the date of each transaction, and the prices paid and received. There is also a column providing for the insertion of an account-sales number. Each contract is entered on a separate line. Thus, the record of 10 contracts purchased is expressed by 10 separate entries, even though they represent one purchase. This is done to obviate any error in closing or setting off such purchases, and to make possible the recording of account-sales reference numbers. These account sales may be rendered at different times, depending upon the manner in which the purchases are disposed of or the short sales covered. They may be closed all at once or at subsequent intervals.

All transactions are classified according to the options involved. Thus, any dealings in the option, May, 1920, are classified in the column headed "May, 1920." Similarly, all purchases or sales of other months are classified in their respective columns.

A loose-leaf arrangement gives the best service in this particular book. As it is tabbed alphabetically, the customers' accounts can also be arranged in that manner. Furthermore, the book can be expanded or contracted. This is a most convenient and desirable feature in the cotton brokerage business, since "dead" accounts can be removed to the transfer binder, while the active accounts are allowed to remain.

No monetary column appears in the customers contract book other than that for entering the price per pound. As may be inferred, the customers' accounts in the ledger are not charged with the cost of purchases or with the proceeds of sales, but show only the profit or loss difference. For example, if John Jones purchases 100 January at 13.08 and sells 100 at 13.20, his account in the ledger is not charged with $6,540 nor credited with $6,600, but is merely credited with his his profit of $60, less commission. Thus this customers con-



Form 13. Customers Contract Book

tract record contains only the options of customers and disregards the money values involved beyond the price per pound.

The difference method employed in charging or crediting accounts to record purchase or sale of futures is not peculiar to the cotton brokerage business. The accounting in all the commodity futures is conducted in the same manner. The system is employed because it is convenient, accurate, and wholly in line with the custom of the business.

Opposed to this method of accounting is that of charging the customer with the amount of his purchase and crediting simultaneously the Contract Differences account. This may be correct in principle, perhaps even more so than the method in vogue, for the reason that it shows the actual debt by the customer who, it is always supposed, will pay for his contract at the time of delivery. In crediting the Contract Differences account, the liability is set up with the clearing house broker and is discharged at delivery time. The same result is accomplished as in the first case, with the additional advantage that the contracts, or options, find expression in a financial way. The use of the first method, however, is supported by the following two good reasons:

1. The contract is purely an option for the receipt or delivery of a specified month's cotton. This cotton may or may not be received or delivered by the contracting parties. In view of the doubt which exists on the part of the customer as to his intention of accepting the cotton or effecting delivery, no charge or credit should be set up, nor should corresponding entries be made in the account with the clearing house. If eventually he means to avail himself of the option he holds, and expresses this intention, a charge for the purchase and a corresponding liability to the clearing house broker would then be warranted.

2. In case of a sale, the grower or the speculator making commitments may not intend to make delivery against the

sale. The sale may have been made for hedging purposes or as a "short flier" in the market. Or the purchaser, say a "spot" man, may have entered the futures market merely to avoid any possible loss from a rise in the price of spot cotton after contractual relations have been entered into between the "spot" man and a mill. If the credit to the customer and a corresponding charge to the clearing house broker were set up, the entries at best would express merely contingencies.

For such reasons it is obvious that nothing is lost and no misstatement is made by treating option transactions by the first method of accounting.

Customers Ledger

The customers ledger is an underlying ledger and does not vary in principle from the ordinary customers or creditors ledger. Hence it does not require further comment. The "Boston" or three-money-column ledger can be used here to good advantage.

General Journal

In cotton brokerage the general journal is put to the usual accounting uses. It is well, however, to call attention to two frequently recurring items in the journal, for which special debit and credit columns are provided. One is "Cash in Sundry Banks," which is charged with deposits wired by out-of-town banks as margin for customers. The other item is the credit entry made in the Customers controlling account, specifying which individual account is to be credited. As an example, Frederick Jones of Sumter, South Carolina, deposits $1,000 with the National Bank of Sumter for the credit of his broker in New York. Upon being advised by the bank, the broker debits Cash in Sundry Banks (National Bank of Sumter) with $1,000 and credits the Customers controlling account with a similar amount.

CASH RECEIPTS

DATE 1919		EXPLANATORY	NET CASH	EXCHANGE AND COLLECTION	CONTRACT DIFFERENCES	CLEARING HOUSE MARGINS	INTEREST ON MARGINS	FOLIO	CUSTOMERS CONTROL ACCOUNT	GENERAL LEDGER
Dec.	1	Balance	50121 10					×		50121 10
	3	Nat'l. Bank Sumter - Draft	500					✓		500
		Cash-Sundry Banks (Sumter Nat'l)	1000					✓		1000
		Contract Differences (Cl. House Draft)	1810		1810					
	5	John Moran - Cashier's Check	199 90	10				C.L 310	200	
	10	Clearing House: margins-released	1000 81			1000	81	M.L 51		
	31	Contract Differences - Cl. House Dft.	90		90					
			54721 81	10	1900	1000	81		200	51621 10
		Cash Receipts	54721 81					✓		
			54721 81	10	1900	1000	81		200	51621 10
Dec.	31	Balance	34258 81	✓	✓	✓	✓	×	✓	34258 81

Form 14. (a) Cash Book (receipts)

CASH DISBURSEMENTS

DATE 1919		EXPLANATORY	NET CASH	CONTRACT DIFFER-ENCES	CLEARING HOUSE MARGINS	GENERAL EXPENSE	SUNDRY EXPENSE	FOLIO	CUSTOMERS CONTROL ACCOUNT	GENERAL LEDGER
Dec.	2	H. K. Jones - check	115					C.L. 17	115	
	3	General Expense - Rent	275			275				
	4	Contract Differences. - Cl. House check	2005	2005						
	7	Clearing House margins deposited	18000		18000			m.L. 51		
	10	Petty Cash - Sundries	18				18			
		Furniture & Fixtures - (Desk)	50					✓		50
	31	Disbursements	20463					✓		
		Balance	34258 81							
			54721 81	2005 ✓	18000 ✓	275 ✓	18 ✓		115 ✓	50

Form 14. (b) Cash Book (disbursements)

General Ledger

The general ledger contains all real accounts, including, of course, the controlling accounts for customers and clearing house margins. A bound book best answers the purposes of this ledger.

Cash Book

The cash book, as shown by Forms 14a and 14b, has special columns, conforming to the needs of the cotton brokerage business. On the cash receipts side of the book are found columns for net cash, exchange and collection, contract differences, clearing house margins, interest on margins, folio, Customers control account, and a general ledger column. On the cash disbursements side the columnarization provides for the same details, with the exception that there is no column for exchange and collection or for interest on clearing house margins. Instead, there are general and sundry expenses columns.

Balancing the Cash Book

The cash book is balanced monthly. The various columns are footed and posted to the respective ledger accounts as follows:

On the cash receipts side, the total appearing in the customers column is posted to the controlling account in the general ledger, it being assumed that the cash payments by customers have been credited daily in the underlying ledger. The total of the contract differences column represents cash received through the clearing house as settlements by other brokers, and hence is credited to the Contract Differences account. The clearing house margins column is posted in bulk to the Clearing House Margins controlling account in the general ledger, it being again assumed that the respective credits, representing released margins, have been posted to the

underlying clearing house margin ledger, which merely records the amount of margin deposited and released from day to day in the regular course of the month. Interest on margins represents earnings, since the interest is earned on margins which have been released. The total of this column is posted to an account in the general ledger called "Interest on Margins." The accounts appearing in the general ledger column have already been posted, making further comment unnecessary.

The disbursements side of the cash book is treated in a similar manner, due regard being paid to the posting of the totals in their respective columns. The Cash account in the general ledger is charged with the receipts and credited with the disbursements for the month. Finally, the balance appearing in the cash book is carried down and the operations for the next month are continued as before.

The difference between the amount paid to the clearing house and the amount received from it as shown by the contract differences column should be reconcilable to the net sum paid or received as shown by the brokers' daily clearing house statements, of which duplicates are retained in the office.

CHAPTER XIX

THE ACCOUNT SALES REGISTER

The Contract Differences Account

The account sales register or analysis journal (Form 15) is a journal in both form and principle. It records financial facts, showing losses or gains in customers accounts. When the customer incurs a loss, the broker who is acting as his agent is called upon to settle for it eventually. At this point one fact is certain—the customer must be charged with the loss incurred and also with the commission on the transaction. The offsetting credit entry is to the Contract Differences account and represents an amount due to the clearing association.

If a customer makes a profit, his account is credited. The Commission account is also credited for the commission. The offsetting debit entry is to the Contract Differences account and represents an amount due from the clearing association.

The Street has possibly adopted a wrong principle in accounting in merging accounts receivable with accounts payable, which shows a balance figure that is sadly in need of analysis. Examining this matter more deeply, however, we shall find that this violation of sound accounting principles is not to be condemned so severely when we consider the system under which the business is conducted. What may be an account receivable, considering the option months separately in the customers division, may result in an accounts payable to the clearing house. The identity of the customers and their individual profits and losses is lost in the clearing house books.

a/c Sales Number	DATE 1920		CUSTOMERS	FOL.	OPTION	CUSTOMERS Dr.	CUSTOMERS Cr.	CONTRACT DIFFERENCES Dr.	CONTRACT DIFFERENCES Cr.	COMMISSION
50	Jan.	2	G. Whitley	✓	500 May	425			300	125
52			S. Sawyer	✓	100 July		35	60		25
53			G. H. White	✓	300 Dec.	15		60		75
54		4	H. Spencer	✓	2000 Jan.		4950	5450		500
55			" "	✓	1000 March	1200			950	250
56		4	W. Sauerwein	✓	700 "	75		100		175
57			J. J. Baxford	✓	400 "		1060	1160		100
58		7	" "	✓	200 Oct.		780	830		50
59			" "	✓	800 Jan.	200				200
60		12	C. M. St. Clair	✓	900 "	45		180		225
61		14	W. W. Engals	✓	4500 Dec.	10650			9525	1125
62			" "	✓	5000 Jan.		2500	3750		1250
						12610	9325	11590	10775	4100

NOTE. The summary of the above transactions would be journalized as follows: Debits, Customers, $3.285; Contracts, $815; Credits, Commission, $4.100

Form 15. Account Sales Register or Analysis Journal

Factors Affecting the Contract Differences Account

Without entering into the question of settlement between brokers, it may be stated here that two factors of settlement in the clearing house have direct bearing upon the Contract Differences account. One is a receipt of cash from brokers through the clearing house; the other is payment to the clearing house for the accounts of brokers. The former indicates that the broker has a claim on the clearing house by reason of profits in the process of collection. The latter carries with it the implication that losses of the customers are being liquidated through the machinery of the clearing house. Moreover, the Contract Differences account is charged or credited with the respective profits or losses incurred or realized on customers' transactions.

Four factors thus enter into the Contract Differences account: (1) charges as offset entries to customers' profits; (2) losses of customers indicated by a credit to the Contract Differences account; (3) receipts from brokers through the clearing house, attesting to payment on account of customers' profits; (4) payments to the clearing house against losses on customers' contracts.

The purpose of conducting a set of clearing house records is to make possible the immediate liquidation against closed or completed contracts. In view of this, no case can be conceived of where the contracts with the clearing house would be settled in the same order as are the contracts of customers. Take as an illustration a purchase of 100 January at 13.08 for the account of John Brown, and a subsequent sale at 13.20 for the same account; also a purchase of 100 March at 13.00 and a subsequent sale at 12.96 for the account of L. Smith. Assume, for convenience, that all these transactions have been made with Hamlin and Company through the New York Cotton Exchange Clearing Association. In the first case, the Contract Differences account is charged with $60, represent-

ing 12 points' profit on the January trade. On the March transaction 4 points, or $20, is lost. The Contract Differences account shows a debit balance of $40, being composed of an account receivable and an account payable. The operations of the clearing house books contemplate, at best, the receipt of $40, regardless of the source of receipt or of the customers with whom profits and losses are settled. This emphasizes the statement that no cognizance is given to the customers' losses or gains as soon as the transactions reach the point of entry in the settling records of the clearing house.

Arrangement and Operation of Account Sales Register

The account sales register or analysis journal is entered from an account sales statement rendered to the customer, which has previously been made up from the customers contract book.

The columnar arrangement of this journal, as shown in Form 15, is as follows: the account sales number; the date; customer's name; folio; number of bales, and option months covered by the account sale; a debit and a credit column for entering losses or gains (always including the commissions) of the customer; a debit and a credit column under the caption of "Contract Differences," where, in the case of a debit or a credit to the customer, a corresponding credit or debit, less the commission, will be found; and finally, a column for the commission earned.

The following illustrations will serve to show the working of this journal. Taking the transactions of John Brown who purchased 100 January at 13.08 and sold at 13.20, the following entry appears:

Debit Contract Differences................	$60.00
Credit John Brown......................	35.00
Credit Commission......................	25.00

Taking the case of a loss of $55 by John Jones, the entry is as follows:

Debit John Jones	$55.00
Credit Contract Differences	30.00
Credit Commission	25.00

If a customer buys 100 January at 13.05 and sells at 13.10 the entry is expressed thus:

Debit Contract Differences	$25.00
Credit Commission	25.00

In this case no entry whatever is made in the customers columns, as the trade, so far as he is concerned, reflects an even settlement.

Or assuming a purchase of 100 January to have been made at 13.05 and to have been sold at 13.05 for the same customer, the entry appears as follows:

Debit Customer	$25.00
Credit Commission	25.00

No entry is made in the Contract Differences columns for the reason that no accounts receivable or payable are created with the clearing house, since the transaction from that end is a flat, or even, settlement.

Recapitulation

The contract analysis journal is a type of special journal, or a complex type book of original entry. Being columnarized, it presents the possibility of allowing controlling accounts in the general ledger, as is done in actual practice. The debit and credit items resulting from either losses or gains of customers are posted daily to the respective customers accounts in the underlying customers ledger. At the end of the period, which is most frequently the end of each month, a recapitulation of the debits and credits is made, and this summary is

posted to the respective accounts affected, including the posting to the Customers controlling account.

To illustrate, let it be assumed that the total debits in the customers debit column are $12,610, that the total credits in the customers credit column are $9,325, making a net debit difference between the two columns of $3,285. If the total in the Contract Differences debit is $11,590 and the total of the credits is $10,775, making a net debit difference of $815, the commission column must total up to a credit of $4,100. In recapitulating, therefore, the following summary appears:

RECAPITULATION

Contract Difference.....	$ 815.00	Commissions...........	$4,100.00
Customers.............	3,285.00		
	$4,100.00		$4,100.00

The Contract Differences account is charged in the general ledger with $815, the Customers controlling account is debited with $3,285, and the Commission account is credited with $4,100.

The recapitulation of the account sales register or analysis journal is necessary before a trial balance of the general ledger can be taken.

Customers Accounts Payable

In the ordinary sense of the term a customer is looked upon as one who purchases, and is therefore charged. When he pays, the account is credited and balanced. Vice versa, a creditor is looked upon as a person from whom goods are purchased or who has yielded any other benefit. But in the brokerage business it is quite different. The customer deposits margins for which his account receives credit. As no other offsetting entry appears, the account becomes an account payable or creditors account. Any losses which may be subse-

quently charged to the account still keep it a creditors account, for seldom is a debit balance account allowed to remain on the books. Thus it follows as an invariable rule that the only accounts kept with customers or clients are accounts payable. For the foregoing reason, besides Accounts Payable, no other controlling account with customers is kept. A practice of charging all uncollectible debit accounts to Profit and Loss prevents the possibility of any accounts receivable appearing beyond a reasonable length of time. In auditing, this rule should be remembered.

Customers' Statements

Unlike stock-brokers, cotton brokers neither charge nor allow interest on customers' balances. Each customer receives a monthly statement of his account, showing the profits and losses arising out of his transactions during the month. When the account in the customers ledger is balanced, a statement is rendered to the customer.

Statement of Open Trades

Besides receiving a statement of settled transactions, each customer receives a statement of open or unliquidated trades. This statement is made out in duplicate, thus furnishing a basis for the compilation of the point balance, which is explained in Chapter XXI.

Account Sales Statement

Form 16 shows the account sales statement which is sent to each customer as soon as a transaction is closed by either purchase or sale against open commitments, and which gives the customer's loss or gain. It will be observed that the transactions are not carried out into dollars, but that only the difference in points is considered, which in turn is resolved into money values.

No. 50 Account Sales of
ADAMS, BURNS AND CONANT

New York, Jan. 2, 1920

Statement of 500 Bales Cotton May 1920 Delivery
Bought and Sold by order and for account of
Mr. J. Whiteley

DATE 1919		BOUGHT	POINTS	DATE 1920		SOLD	POINTS
Dec.	3	200 @ 1252	2504	Jan.	2	500 @ 1215	6075
	7	100 " "	1232				
	22	100 " "	1207				
	29	100 " "	1192				
			6135				6075
			6075				
			60				
						Loss 60 pts	$ 300
						CHARGES	
						COMMISSION	125
		E & O E. CRO				NET Loss	$ 425

Form 16. Account Sales Statement

Commission Rates

The New York Cotton Exchange prescribes commission rates which its members may charge customers as follows:

1. Ten dollars for each and every one hundred bales bought or sold when the transaction is made for any person not a member of the Exchange, provided the price at which such transaction is made is below 13.01 cents per pound.

2. Twelve dollars and fifty cents for each and every one hundred bales bought or sold when the transaction is made for any person not a member of the Exchange when the price at which such transaction is made is within a range of 13.01 cents per pound to 25 cents per pound, inclusive.

3. An additional two dollars and fifty cents for each and every one hundred bales bought or sold when the transaction is made for any person not a member of the Exchange for transactions within each range of 5 cents per pound above 25 cents per pound.

4. Rates for members shall be one-half of the above rates.

4a. In addition to the above rates of commission there shall be an additional charge of $2.50 for each and every 100 bales bought or sold for non-members residing outside the United States and Canada, and an additional $1.25 for each and every 100 bales bought or sold for members residing outside the United States and Canada.

5. One dollar for each and every hundred bales bought or sold by one member for another, giving up his principal at or before the close of the Exchange on the day of the transaction, provided the price at which such transaction is made is below 13.01 cents per pound. One dollar and twenty-five cents for each and every hundred bales bought or sold by one member for another, giving up his principal at or before the close of the Exchange on the day of the transaction, when the price at which such transaction is made is within a range of 13.01 cents per pound to 25 cents per pound, inclusive. An additional twenty-five cents for each and every hundred bales bought or sold by one member for another, giving up his principal at or about the close of the Exchange on the day of the transaction, for transactions within each range of 5 cents per pound above 25 cents per pound.

CHAPTER XX

COTTON CLEARING ASSOCIATION

Weaknesses of Old System

In 1914 the idea was conceived of organizing an institution separate and distinct from the Cotton Exchange, which would have as its object the clearing of contracts between brokers resulting from their daily purchases and sales. Up to that time the system of clearing was unsound, in that severe fluctuations of market prices made it very difficult for members of the Exchange to arrange their finances in such a manner as to facilitate the compulsory margining of options into which they had entered with other brokers. The old system was so carelessly arranged as to place within the hands of members the right to decide as to whether contracts should be margined on the day of demand or should be deferred until the following business day. It is easy to see that where brokers had contractual relationships which continued sometimes for a period of 11 months, it was a matter of protection for them to compel others to make good any price changes.

As an example of this, let it be assumed that broker A purchased of broker B 1,000 bales of January cotton at 13 cents per pound. Both continued in this relationship of buyer and seller until the contract was settled, either through an offset purchase or sale at a subsequent date, or through the delivery of the cotton at the expiration of the option. In the meantime, however, the cotton might have fluctuated back and forth 10 cents per pound. If cotton sold at 23 cents, A might have been anxious concerning the fulfilment of the contract by B because of the huge advance from the contract price of 13 cents. Consequently, A would issue B a margin call, the receipt of which

would compel B to deposit with a trust company a sufficient sum to protect A against any loss in the event of B's failure to deliver. Conversely, if cotton sold at 8 cents per pound subsequent to the time of making the original commitment, B would be concerned as to whether A would be in a financial position to receive cotton from him at the contract price of 13 cents. As a protective measure, B would now issue a margin call to A, and upon receipt of it A would be compelled to deposit margin with a trust company sufficient to compensate for the decline of 5 cents in the price.

Another weakness of the old system was to be found in the inability to transfer commitments to other brokers. Reverting to the purchase of A from B, it might have happened that A subsequently sold 1,000 bales of January cotton to C. A, therefore, actually had no January cotton, so far as his position was concerned; but as he had certain contractual relationships which he would be compelled to fulfil with B and C, it would be very difficult indeed for A to assign his interest in his contracts to C with the knowledge and consent of B.

The third weakness was in the manner of payment in connection with offsetting contracts. The absence of a responsible intermediary person or institution was keenly felt by all members.

These deficiencies gave rise to the present clearing association. Through the rules formulated, as stated in Appendix D, brokers are now compelled to file with the clearing house a daily settlement sheet, the detail of which is discussed below.

"Sign-up Slip" Contract

After the purchases and sales of the day are made, the contracting brokers are compelled to sign a written contract. This contract or "sign-up" slip contains the date of the transaction, the number of bales purchased, the option months, and the price. Reference is made to the by-laws and rules of the

New York Cotton Exchange governing the contract, and reference is also made to the United States Cotton Futures Act, Section 5. Upon completion of the purchase or sales, these contracts are signed by the respective parties and are then sent to the offices of the brokers. The slips are used for completing the data in the brokers' offices.

Purchases and Sales Book

The purchases and sales book appears among both the customers and the clearing house records. While its most important feature is the record of purchases or sales for the customer and this information is the basis of entry for the customers records, the same purchases and sales book also supplies information for clearing house purposes. In the clearing house division, the names of contracting brokers and the number of bales contracted for are essentials, the customer's identity being wholly lost.

Cotton Contract Blotter

The clearing house blotter, or contract blotter (Forms 17a and 17b) is written up from the purchases and sales book. Its arrangement is such that each current option month is allotted a separate section. There are commonly found eight sections, providing for the following options: January, March, May, July, August, October, December, and sundry months. Each "contract" is entered separately and the purchase of 1,000 bales, when signed up, necessitates the making of ten separate entries.

Unlike the blotter used in the stock brokerage business, the book as used here is not a financial record. Its purpose is to gather information for further use in preparing the clearing house sheet. The sign-up slips, or forms of contract, bearing the names of the contracting parties, are used for the purpose of making the blotter record complete. Thus the ruling of the

COTTON CONTRACT BLOTTER—Bought for May 1920 Delivery

Date Dec. 3, 1919

BALES	FROM WHOM	PRICE		CUSTOMER
100	Sales & Co	12	52	G. Whitley
100	"	12	52	"
100	"	12	52	"
100	"	12	52	"
100	"	12	52	"

Form 17. (a) Cotton Clearing House Blotter (left)

COTTON CONTRACT BLOTTER—Sold for May 1920 Delivery

Date Jan. 2, 1920

BALES	TO WHOM	PRICE		CUSTOMER
100	Mayer & Co	12	15	G. Whitley
100	"	12	15	"
100	"	12	15	"
100	"	12	15	"
100	"	12	15	"

Form 17. ( ) Cotton Clearing House Blotter (right)

book must allow for the following information: the number of bales listed in single hundreds, the contracting broker's name, the price of purchase or sale, and the name of the customer purchasing or selling. With the blotter thus complete, the next step in the bookkeeping procedure is the preparation of the clearing house sheet.

Memorandum of Purchase

The clearing house provides forms on which all transactions made during the day are to be entered, and compels a grouping of contracts with special regard to option months. Thus, all purchases in January, March, May, July, October, and December are to be found under the respective groups.

NEW YORK, Dec. 28, 1920

BOUGHT BY Adams, Burns and Conant

AND CONTRACTS OFFERED TO NEW YORK COTTON EXCHANGE CLEARING ASSOCIATION, INC. FOR CLEARANCE IN ACCORDANCE WITH ITS BY-LAWS AND RULES.

FROM WHOM BOUGHT	NO. BALES	MONTH	PRICE	SETTLING PRICE	DEBIT	CREDIT
Sales + Co.	500	Jan.	28.90	29.00		250
"	500	"	28.78	29.00		550
	1,000					800
Hogdow + Co.	300	Mar.	28.03	28.50		705
	300					705
Logan + Co.	200	May	29.61	28.40	1 210	
J. S. Bates + Co.	300	"	29.60	28.40	1 800	
	500				3 010	—
TOTALS	1800				3 010	1 505
BALES AND MONEY TOTALS FORWARD						

Form 18. (a) Clearing House Memorandum of Purchases (first day)

The arrangement of this memorandum of purchases (Form 18a) makes it possible to record the name of the broker from whom the option has been purchased, the number of

bales, the name of the option month, and the price. In addition, there is a column headed "Settling Price," which is followed by a debit and a credit column for the purpose of entering money values.

Sales Memorandum

Under the same ruling, the clearing house compels a classification of sales, and the arrangement of the sales memorandum

NEW YORK, Dec. 28, 1920

SOLD BY Adams, Burns and Conant

AND CONTRACTS OFFERED TO NEW YORK COTTON EXCHANGE CLEARING ASSOCIATION, INC. FOR CLEARANCE IN ACCORDANCE WITH ITS BY-LAWS AND RULES.

TO WHOM SOLD	NO. BALES	MONTH	PRICE	SETTLING PRICE	DEBIT		CREDIT	
	500	Jan.	28.53	29¢	1	175		
	500				1	175	–	
	200	Mar.	29.40	28.50				900
	200							900
	100	May	27.91	28.40		245		
	100					245	–	
TOTALS	800				1	420		900

BALES AND MONEY TOTALS FORWARD

Form 18. (b) Clearing House Memorandum of Sales (first day)

(Form 18b) is similar to that of the purchase memorandum, with the exception that the first column is headed "To Whom Sold."

Settling Prices

At the close of business each day authorities of the association declare, through publication, the price at which contracts are to be cleared or settled for that day. These settling prices

are determined by the bid and asked quotation of the day for each option.

The broker who has purchased 1,000 bales of January on December 28 is compelled to adjust any money differences with the clearing house on the sheet of that particular day, and these money differences are settled through deposit of a check by the broker, if the fluctuations are against him, or the issuance of a draft by him on the clearing house, if the fluctuations are in his favor. To illustrate, assume that the settlement price for January cotton is 29.00. The broker who purchased at 28.78 and 28.90 cents is compelled to enter in the credit column on the purchase sheet the sum of $800 after applying the clearing house price of January against the January purchases. Each column of purchases is subtotaled. The broker then proceeds to adjust his March and May purchases in the same manner, and so on throughout until he has applied the respective settling prices against all the options appearing on the purchase memorandum. The columns are now grand-totaled.

The same procedure is followed with the sales memorandum. In this connection it should be recalled that if the settling price be lower than the selling price the difference is listed in the credit column, whereas if the settling price be higher than the selling price the difference is listed in the debit column. After applying the clearing house price against all the sales for the day, the subtotals of the respective option months are grand-totaled.

The Clearing House Sheet

The arrangement of the clearing house sheet (Form 19) is as follows: There are six general columns. The first bears the title "Carried Over For Tomorrow," and the caption headings of its three subdivisions are "Long," "Month," "Short." The next general column is headed "Today's Trading," and is subdivided into three columns having the following captions

"Bought," "Month," "Sold." The third general column is designated as "Carried Over From Yesterday," and here the subdivisions are captioned "Long," "Month," "Short." Under the month columns provision is made for the names of all

RECAPITULATION. STATEMENT OF *Adams, Burns and Conant* TO THE

NEW YORK COTTON EXCHANGE CLEARING ASSOCIATION, INC.

THIS MEMORANDUM MUST BE DELIVERED AT THE OFFICE OF THE ASSOCIATION BEFORE 12:05 A.M. WITH CHECK OR DRAFT FOR NET BALANCE SHOWN HEREON, AND ALSO A SEPARATE CHECK FOR ORIGINAL MARGIN IF REQUIRED.

NEW YORK, *Dec. 28,* 1920

CARRIED OVER FOR TO-MORROW			TO-DAY'S TRADING			CARRIED OVER FROM YESTERDAY			SETTLING PRICE		DEBIT		CREDIT	
LONG	MONTH	SHORT	BOUGHT	MONTH	SOLD	LONG	MONTH	SHORT	YESTERDAY	TO-DAY				
500	JANY.		1,000	JANY.	500	✓	JANY.			29.00		–	–	
·	FEBY			FEBY.			FEBY.							
100	MARCH		300	MARCH	200	✓	MARCH			28.50		–	–	
	APRIL			APRIL			APRIL							
400	MAY		500	MAY	100	✓	MAY			28.40		–	–	
	JUNE			JUNE			JUNE							
	JULY			JULY			JULY							
	AUGUST			AUGUST			AUGUST							
	SEPT.			SEPT.			SEPT.							
	OCT.			OCT.			OCT.							
	NOV.			NOV			NOV.							
	DEC.			DEC.			DEC.							
1,000	TOTAL		1,800	TOTAL	800		TOTAL		DIFFERENCES ON OLD CONTRACTS					
T/N STOPPED	DUE DATE DELIVERY	T/N ISSUED	·	ORIGINAL	MARGIN	MEMORANDUM			BOUGHT	SHEET	3	010 ✓	1	505
							MARGIN	REQUIRED	SOLD	SHEET	1	420 ✓		900
			NET INTEREST		1,000	BALES @ 10	10	000	TOTALS		4	430	2	405
			STRADDLE	INTEREST				—	CREDIT VARIATION MARGIN			–	–	
			EXCESS PREMIUM	MARGIN (IF		ANY)		–						
	TOTAL					TOTAL	10	000		NET	(CHECK) 2	025	(DRAFT) –	
	PREVIOUSLY		FACE VALUE	BONDS @ 90										
	DEPOSITED			CASH										
				TOTAL										
			RELEASED	(IF ANY)										
				BALANCE										
		CHECK FOR	DEFICIENCY	(IF ANY)	10	000	(TOTAL 10	ON DEPOSIT) 000						

Form 19. Clearing House Sheet (first day)

option months. The fourth general column provides for the settling price and is so described. It is subdivided into two columns bearing the titles "Yesterday" and "Today." The fifth column is a monetary column with the caption "Debit," and the sixth and last column in the form bears the title "Credit."

The first step in the preparation of a clearing house sheet is the recording of the day's trading, and for that purpose the

purchase memorandum and the sales memorandum are used. The totals of January, March, May, July, October, and December purchases and sales are listed in the first and third subdivisions of the second general column. The grand total on the purchase sheet is also listed on the clearing house sheet. The same holds true of the total sales taken from the sales memorandum.

To illustrate, assume that there were no contracts carried over from yesterday (December 27). The third general column in the clearing house sheet need not, therefore, concern us for the time being. Nor would yesterday's settling price, called for in the fourth division, concern us, as it is assumed that trading begins today. The settling price of "Today," however, is inserted in the subdivision of the fourth column, for the purpose of providing the basis for tomorrow's application of the new settling price which will be issued by the clearing house. The next matter to consider is what shall be stated in the debit and credit columns on the clearing house sheet. For this information, we must again refer to the purchases and sales memorandum. The grand debit and credit totals on the purchases and sales memorandum sheets are inserted below the settling price column where provision is made for listing the information called for. On one line opposite the debit column appears the statement "Differences on Old Contracts," and below that, the words "Bought Sheet," which are followed by the words, "Sold Sheet." The grand debit and credit totals on the purchases and sales memoranda are now filled in opposite the words "Bought Sheet" and "Sold Sheet," and a grand total is made opposite the word "Totals," which appears below the heading "Sold Sheet." The difference between the debit and the credit columns on the clearing house sheet is now taken off and carried down below the "Totals" line, opposite the word "Net" (debit or credit).

If the result is a net debit, the broker sends his check pay-

able to the clearing association for that amount. If the result is a net credit, the broker draws a draft on the clearing house for the amount called for. After this draft has been approved by the manager of the clearing association, it becomes bankable.

Completing the Sheet

The final steps in preparing the first day's recapitulation with the clearing house is to carry over to tomorrow the net commitments, divided into the respective option months in which the broker is interested. By referring to Form 19 it will be found that there must be carried over 500 January, 100 March, and 400 May, a total of 1,000 bales. These items are entered in the first column of the settling sheet. The last step concerns itself with the original margin memorandum appearing at the bottom of the recapitulation statement. Since the broker's net interest is 1,000 bales, that figure is entered to the right of the words "Net Interest," and under the caption "Margin Required" the sum of $10,000 appears. This figure is again repeated in the total column. As no margin was previously deposited, we pay no attention to the questions referring to previously deposited margins. However, opposite the words "Check for Deficiencies (if any)" the sum of $10,000 is entered and again stated under the "Total on Deposit" column. The sheet, together with the purchases and sales memoranda, and accompanied by a check or draft for contract differences and a check for original margins, is deposited with the association before 12:05 A.M. of the next day.

Second Day's Sheet

The second day's sheet (Form 20) will be found to begin with a declaration of the options carried over from yesterday, which in the present case are 500 January, 100 March,

and 400 May, a total of 1,000 bales. Also, under the settling price column and in the subdivision providing for yesterday's prices, the following figures appear:

29.00 opposite January
28.50 opposite March
28.40 opposite May

RECAPITULATION. STATEMENT OF *Adams, Burns and Conant* TO THE

NEW YORK COTTON EXCHANGE CLEARING ASSOCIATION, INC.

THIS MEMORANDUM MUST BE DELIVERED AT THE OFFICE OF THE ASSOCIATION BEFORE 12:05 A.M. WITH CHECK OR DRAFT FOR NET BALANCE SHOWN HEREON, AND ALSO A SEPARATE CHECK FOR ORIGINAL MARGIN IF REQUIRED.

NEW YORK, *Dec. 29,* 1920

CARRIED OVER FOR TO-MORROW			TO-DAY'S TRADING			CARRIED OVER FROM YESTERDAY			SETTLING PRICE		DEBIT		CREDIT	
LONG	MONTH	SHORT	BOUGHT	MONTH	SOLD	LONG	MONTH	SHORT	YESTERDAY	TO-DAY				
800	JANY.	—	300	JANY.	—	500	JANY.		29.00	28.50	1	250		
	FEBY.			FEBY.			FEBY.							
—	MARCH	—	—	MARCH	100	100	MARCH		28.50	28.10		200		
	APRIL			APRIL			APRIL							
—	MAY	—	—	MAY	400	400	MAY		28.40	28.00		800		
	JUNE			JUNE			JUNE							
	JULY			JULY			JULY							
	AUGUST			AUGUST			AUGUST							
	SEPT.			SEPT.			SEPT.							
	OCT.			OCT.			OCT.							
	NOV.			NOV.			NOV.							
	DEC.			DEC.			DEC							
800	TOTAL		300	TOTAL	500	1,000	TOTAL	—	DIFFERENCES ON OLD CONTRACTS		2	250		
T/N STOPPED	DUE DATE DELIVERY	T/N ISSUED	ORIGINAL MARGIN MEMORANDUM						BOUGHT SHEET			—		150
							MARGIN	REQUIRED	SOLD SHEET			250		
			NET INTEREST		800	BALES @ 10	8	000	TOTALS		2	500		150
												—	—	
			STRADDLE	INTEREST	—			—	CREDIT VARIATION	MARGIN		—	—	
			EXCESS PREMIUM MARGIN (IF ANY)					—						
	TOTAL					TOTAL	8	000		NET	(CHECK) 2	350	(DRAFT) —	
	PREVIOUSLY		FACE VALUE —	BONDS @ 90		—								
	DEPOSITED			CASH	10	000								
				TOTAL	10	000								
			RELEASED	(IF ANY)		—								
				BALANCE	10	000	10	000 (TOTAL ON DEPOSIT)						
		CHECK FOR	DEFICIENCY	(IF ANY)		—								

Form 20. Clearing House Sheet (second day)

Below the line, and under the caption "Original Margin Memorandum," the figure of $10,000 will be found opposite the words "Previously Deposited." This is classified as cash margin since that was the form of the deposit. This amount is again shown in the same column in the space opposite the word "Balance."

Let us assume that on his second day in business the broker purchases 300 bales of January at 28.40 and that he sells 100 March at 28.00 and 400 May at 27.90. These purchases and sales are entered on the memorandum sheets (Forms 21a and 21b) and the respective transactions are transferred to the

NEW YORK, Dec. 29, 1920

BOUGHT BY Adams, Burns and Conant

AND CONTRACTS OFFERED TO NEW YORK COTTON EXCHANGE CLEARING ASSOCIATION, INC. FOR CLEARANCE IN ACCORDANCE WITH ITS BY-LAWS AND RULES.

FROM WHOM BOUGHT	NO. BALES	MONTH	PRICE	SETTLING PRICE	DEBIT		CREDIT	
Johnson + Co	300	Jan.	28.40	28.50	—			150
	300				—			150
TOTALS	300							150

BALES AND MONEY TOTALS FORWARD

Form 21. (a) Clearing House Memorandum of Purchases (second day)

recapitulation sheet in the same manner as already explained in connection with the preceding day's trading.

Assume that the settling price for January is 28.50; for March 28.10; and for May 28.00. These prices are entered in the settling price column on the sheet under the caption "To-day." Assume also that these settling prices are applied respectively on the purchases and sales memoranda, resulting in a credit in the January group of $150. Since 300 January aggregates the total purchases for the day, the credit column on the purchase sheet totals $150. The sales sheet reports the sale of 100 March and 400 May, and in the debit columns opposite

the March group a debit of $50 appears, and opposite the May group a debit of $200, or a total of $250 as the aggregate debit. Hence, in the debit and credit columns on the clearing house sheet (Form 20) opposite the words "Bought Sheet" and

NEW YORK, Dec. 29, 1920

SOLD BY Adams, Burns and Conant

AND CONTRACTS OFFERED TO NEW YORK COTTON EXCHANGE CLEARING ASSOCIATION, INC. FOR CLEARANCE IN ACCORDANCE WITH ITS BY-LAWS AND RULES.

TO WHOM SOLD	NO. BALES	MONTH	PRICE	SETTLING PRICE	DEBIT	CREDIT
A A Horseman	100	Mar.	28.00	28.10	50	
	100				50	–
Jones & Co.	100	May	27.90	28.00	50	
Rodden & Co.	100	"	27.90	28.00	50	
Norbin & Co	100	"	27.90	28.00	50	
Sprungs & Co	100	"	27.90	28.00	50	
	400				200	–
TOTALS	500				250	–

BALES AND MONEY TOTALS FORWARD

Form 21. (b) Clearing House Memorandum of Sales (second day)

"Sold Sheet" the figure of $150 appears in the credit column and the figure of $250 appears as a debit opposite the words "Sold Sheet."

Adjustment of Differences

The next step is to adjust the differences in settling price between yesterday and today on the contracts carried over from yesterday. Since the 500 January carried over from yesterday were calculated at 29.00 and today at 28.50, a total loss of 250 points, or $1,250, should appear in the debit column on the clearing house sheet. Since 100 bales of March were settled yesterday at 28.50 and today at 28.10, a variation of

40 points, or $200, should be recorded. Applying the adjustment and settling prices on the 400 May, a difference of 160 points, or $800, should be recorded. As a result of these adjustments the old contracts carried over from yesterday reveal total differences of $2,250. Adding the $2,250 debit to the $250 appearing opposite the words "Sold Sheet," the total in the debit column is $2,500, whereas the total credit opposite the words "Bought Sheet" amounts to $150. The net difference between the debit and the credit columns amounts to $2,350, for which the broker is indebted to the clearing association, and a check for that amount accompanies the sheet. The concluding steps in the completion of the second day's statement are concerned with the carrying over for tomorrow of open contracts and the adjustment of original margins.

As the broker carried over from yesterday 500 January and purchased 300 bales additional today, the total carried for tomorrow or on the third day's sheet is 800 January. The broker carried over from yesterday 100 March which have been sold today. He also carried over 400 May which have been liquidated. There are therefore no March or May contracts to carry over to the third day. Consequently, the total carried over to the third day, entered under that caption in the clearing house sheet, is 800 bales.

The original margin memorandum must be made to show that the broker's net interest is now only 800 bales, which, calculated at, say, $10 per bale, makes the margin required $8,000. This amount is repeated in the total column below. We must now turn back to the sheet (Form 19) on which it is stated that the total previously deposited was $10,000. Since the broker now requires $8,000, no check for any deficiency is necessary. Conversely, the broker will be able tomorrow, that is, on the third day, to release $2,000 of the original margins. The third day's sheet is prepared in the same manner as the second day's, the only difference being that

suitable provision is made for the amount of margins which have been released the third day.

Original Margins

According to the rules of the clearing association all brokers are required to deposit with that institution original margins, the purpose of which is to guard against the possibility of insolvency of its members. It should be recalled in this connection that under the old system margins between brokers were not promptly adjusted, because the amount of the bank balance would sometimes determine whether a broker would answer a margin call immediately or on the following day. It was purely a matter of moral obligation on the part of the broker.

Under the new procedure, however, margins must be deposited with the clearing association on the day they are due. The margin checks are accompanied by instructions to the clearing house directing it to redeposit these checks with the bank or trust company to whose order they are issued. They are payable either to the broker depositing or to the New York Cotton Exchange Clearing Association. In case of a broker's insolvency, the authorities have the right to use the funds for the benefit of his creditors. The banks or trust companies with whom margin checks are deposited are designated by the New York Cotton Exchange.

While we are on the subject of creditors, it should be stated most emphatically that the clearing association is but an intermediary between two contracting brokers, whose respective liabilities are unlimited until the expiration or the liquidation of contracts or options between them. The association assumes no guarantor's liability, as the object of its establishment was to furnish a safe and convenient system by which members of the Cotton Exchange could conveniently clear their transactions.

Interest on Margins

On the deposit of original margins interest is allowed by the depositories at the rate of 2% or 3%. Banks and trust companies compete for deposits by allowing as high a rate as possible.

Variation Margins

Referring to the clearing house sheet, or statement of recapitulation, it will be observed that suitable provision is made for what are referred to as "variation margins." Between the hours of 10 A.M. and 3 P.M. the cotton market may fluctuate very erratically, and unless a rule is established giving the clearing association the right to demand funds to adjust temporarily the price changes between brokers during the day, great losses might be sustained by some brokers as the result of the insolvency of others. Accordingly, if the clearing association finds that a broker's sheet represents him as being long of 5,000 bales on which the market price has declined 1 cent during the day, it issues at once a variation margin call to the broker, who is compelled to deposit immediately with the clearing association a sum sufficient to offset the change in the price on his contracts. The check is issued to the order of the clearing association and is credited on the clearing house sheet of the same day opposite the words "Variation Margin." In the books, Contract Differences is charged. If at the close of the market the prices approach the previous day's settling prices, the broker recovers the amount of the variation margin, minus or plus any adjustments occasioned through the application of today's settling prices against open contracts which appear on his recapitulation statement. If, on the other hand, the prices do not recover, the broker has merely paid in advance to the clearing house the amount which he would be compelled to pay as the result of adjusting yesterday's and today's settling price on his open commitments.

Contract Differences

In Chapter XIX reference was made to the journalization of profits and losses resulting from closed transactions. The complement, or offsetting account against these profits or losses was stated to be Contract Differences. On similar principles payments made to or received from the clearing association as a result of clearing house adjustments are charged or credited to the same Contract Differences account in the ledger.

The rules and regulations of the Cotton Clearing Association are given in Appendix D. As they bear directly upon the work of the clearing house department, they should be studied carefully in connection with this chapter.

CHAPTER XXI

CONTRACT DIFFERENCES AND THE POINT BALANCE

Requirements as to Records

The records of the cotton brokerage business must be kept up to date. This is even more necessary in the cotton business than in the stock business, for the day's operations depend absolutely upon the information furnished by the various accounting media. If customer X desires to sell his longs or cover his shorts, recourse must be had to X's account in either the customers contract book or the customers margin sheets. In the course of a day's transactions several telegrams from out-of-town clients are received in which orders are given to close out longs or cover shorts, not stating in what options these clients are interested. This illustrates how essential it is to have the accounts completely written up. To exercise a double check upon the accuracy of customers' holdings, it becomes necessary for the margin clerk and the bookkeeper to compare open contracts of clients very frequently.

At any given time it should also be possible for the clerk in charge of the clearing house department to prove the net interest, long and short, taken from his clearing house books, with the net number of bales, long and short, as they appear in the customers records. By classifying the various contracts into months the net interest in each option can also be determined, upon the theory that the same purchases and sales, leading up to the determination of the net long and short, are passed through both divisions—customers and clearing house. As was indicated, the clearing house section concerns itself with the settlement with brokers through the medium of the

clearing house, and the broker's net interest in the market equals the customers' net interests.

It is easily seen, therefore, that there may be a wide divergence between the books of the two divisions. Suppose customers X, Y, and Z purchase in the aggregate 5,000 bales of January options and that customers M and H sell 3,000 bales. The net interest which the broker has in the market for the account of his customers is 2,000 bales long. Even if it be supposed that all the contracts traded in have been in the January option, no close-out or settlement by account sales can be made with the customers, because the purchases and sales have been made for several different accounts. Only where a client buys and sells in the same option month can an account sales be rendered to him. The status of the accounts, individually taken, is such that long contracts are shown for some customers, while short contracts of the same option months are shown for other customers.

The clearing house division takes no cognizance of such a condition existing among customers. As before stated, its purpose is to settle contracts of the same month regardless of other conditions. The 3,000 bales of January bought and sold in the foregoing illustration are settled through the clearing house before—and probably long before—the customers have liquidated their holdings.

Contract Differences Account

This brings us again to the subject of contract differences. If one division of the broker's office works in total disregard of the apparently logical succession of operations involved in the settlement of contracts, then the results obtained from the clearing house books will be in apparent contradiction to those obtained from the customers records. This fact was emphasized in the preceding illustration of a transaction in 3,000 bales of January, upon which payment was either made or

received long in advance of any charges or credits being made in customers accounts.

A thorough understanding of the theory upon which the Contract Differences account operates makes necessary the division of the subject under two headings:

1. Treatment of the customers' transactions as open contracts and liquidated contracts.
2. Treatment of the same transactions with the clearing house.

Transactions which are settled for customers, representing purchase and sale, create either a debit or a credit to Contract Differences, as explained in Chapter XIX. A debit to that account signifies that the clearing house owes a sum which equals the gross profit of the customer on a given transaction. A credit to the Contract Differences account evidences the liability of the broker to the clearing house on account of his customers' losses. Excluding all other factors at this point, the difference—the Contract Differences account—shows the sum owing to or by the clearing house. Of course, it is presupposed that all customers' holdings, long and short, have been closed. If such be the case, then the immediate relation between the customers books and the clearing house books is not so greatly strained.

This, however, is seldom the case. The broker is an agent. As such he is called upon to settle with the clearing house on account of his customers' losses and collect from it on account of their profits; and unless the clearing house division is able to pay or collect on the contracts in question with equal rapidity, the results shown by the customers books and the clearing house books may be widely different.

In the case of a loss, the Contract Differences account shows the corresponding liability to the clearing house. For instance, if the total loss is $800, a payment of cash to the

clearing house offsets the Contract Differences account by a debit to it and a credit to cash. This simple hypothetical illustration shows one phase of the Contract Differences account.

As soon, however, as actual practice is considered, the Contract Differences account assumes a very different aspect. For instance, the contracts from the clearing house end might create charges or credits long before the contracts were settled in the customers accounts. It may be said that if all contracts were closed with the clearing house and with customers, let us say at a time of dissolution, the net losses or the net profits on customers contracts would equal the amount of cash paid to or received from the clearing house.

Point Balance

How, then, is it possible at any other time to prove the correctness of the Contract Differences account? How is it possible to prove the accuracy of the debit, representing an asset, or the credit, representing a liability?

The answers to the foregoing questions require a discussion of the "point balance" method of reconciling the Contract Differences account.

The closed contracts of customers and settled contracts in the clearing house give rise to charges and credits in the Contract Differences account. The open contracts of customers and unsettled contracts in the clearing house will, when finally liquidated, create further charges and credits to the account in question. But meanwhile it becomes necessary to reconcile the Contract Differences account, because only by means of it is a control of the clearing house books possible.

The assumption that this question is one for the auditor to answer is erroneous, because a constant check upon the clearing house books is essential to assure accuracy in the operation of the business. For this reason a point balance is taken at the close of each month or sooner, to prove the

balance in the Contract Differences account. The process of taking a point balance can best be explained by a concrete example such as is found in actual practice. We shall therefore follow a series of items through the customers' division, and through the clearing house division as well. On January 22, the following purchases were made for a client:

200	March	at	30.60
300	"	"	30.70
500	"	"	30.75

On the same day the following purchases were made for other clients:

200	July	at	30.50
300	October	"	30.32

On January 26, the customer who purchased 1,000 March sold:

400	March	at	30.82
100	"	"	30.81

leaving a balance long of 500 March at 30.75.

On January 28, 500 July were sold at 30.31, representing a short sale on the part of another client.

On January 30, 500 December were sold short at 30.20.

From the customers' standpoint the only transactions which were closed by an account sales were the 200 March at 30.60 and 300 March at 30.70, against the sale of 400 at 30.82 and 100 at 30.81. The gross profit to the customer was 79 points, or $395. Consequently the Contract Differences account was charged with a like sum, the customer being credited with $245 and the Commission account with $150. We are primarily concerned with the charge to the Contract Differences account, for it is this account which is to be treated in relation to the point balance, the other factors, such as commission and customers charges or credits, having no bearing on the question at present.

The only charge thus far in the Contract Differences account is $395. The operations which took place in the clearing house division were very different in nature. Because of the complex nature of the clearing house adjustments on the dates of January 22 to January 30 inclusive, we will take again the purchases and sales and apply to them the settling prices as of January 30. We must also take the debits and credits in the Contract Differences account arising out of payments to or receipts from the clearing house on account of the clearing house price adjustments from day to day. On January 22, the clearing house sheet showed 1,000 March, 200 July, and 300 October purchased. After applying the settling price for March that day, which, let us say, was 30.50, for July 30.10, and for October 30.00, the payment made to the clearing house on account of price adjustments amounted to $1,905, for which a check was sent to the association. This entailed the making of a cash book entry, charging Contract Differences with $1,905 and crediting cash with a like sum. Assume for the sake of illustration that a holiday intervened between January 22 and January 26. According to the purchases and sales book, sales were made through the clearing association of 400 March at 30.82 and 100 March at 30.81, which reduced the March position in the clearing house by 500 bales, thus making the broker long with the clearing house of 500 March, 200 July, and 300 October as of January 26. We again proceed in applying the settling prices as of January 26 against open contracts carried over from January 22. On this day the settling prices were:

March	at	30.90
July	"	30.40
October	"	30.30

After going through the process of preparing the clearing house sheet of January 26, the adjustments in settling prices

resulted in a receipt from the clearing house of $2,545, which occasioned the making of the following cash book entry: debit cash $2,545, credit Contract Differences account $2,545.

On January 28, 500 July were sold at 30.31. On the sheet for that day the settling prices were as follows:

March	at	31.00
July	"	30.50
October	"	30.40

After adjusting the price changes, the net result revealed a further receipt from the clearing house of $25, which made necessary the following cash book entry: charge cash $25; credit Contract Differences account $25.

As of January 28 the following contracts were "long" in the clearing house:

500 March,	settling	price	31.00
300 October,	"	"	30.40

The following was "short" in the clearing house:

300 July,	settling	price	30.50

On January 30, 500 December were sold at 30.20. The settling price on December was 30.20, whereas the other settling prices remained the same as of January 28. As a result of this condition, no payments to or receipts from the clearing house were necessary.

To recapitulate, the clearing house books showed:

500 March,	long,	settling	price	31.00
300 October,	"	"	"	30.40
300 July,	short,	"	"	30.50
500 December,	"	"	"	30.20

The open commitments for customers were:

500 March,	long	at	30.75
200 July,	"	"	30.50

300 October,	long	at	30.32
500 July,	short	"	30.31
500 December,	"	"	30.31

The Contract Differences account (Form 22) appeared with the following debits and credits: a debit of \$395 as a result of the closed transactions of customers; a debit of

Customers	$	395 –	Cash (C.H.)	$	2 545
Cash (C.H.)		1 905 –	" "		25
Balance		270			
		2 570			2 570
Account #1			Balance	$	270 –A

Form 22. Contract Differences Account

\$1,905 as a result of a payment to the clearing association; and credits of \$2,545 and \$25 as a result of receipts from the clearing house. As the total debits were \$2,300 and the total credits \$2,570, there was a net credit in the Contract Differences account of \$270, to verify which is our next task.

Proof of Contract Differences Account

Assume that the last of the month has arrived, that we set about to prove by means of the point-balance system, that the credit balance of \$270 is correct. The procedure is as follows:

1. As all contracts are reducible to points, we proceed to extend all open contracts of customers in this manner. Thus, on

the purchase side of the Customers Open Trades the points representing the open contracts are determined in the following manner:

500 March	at 30.75	equals	15,375	points
200 July	" 30.50	"	6,100	"
300 October	" 30.32	"	9,096	"
Total.............			30,571	"

2. On the sales side, the points are found, thus:

500 July	at 30.31	equals	15,155	points
500 December	" 30.20	"	15,100	"
Total.............			30,255	"

3. Deduct the lesser number of points from the greater and we have: 30,571 minus 30,255 equals 316 points debit.

4. Construct a "dummy" ledger account (Form 23) called "Contracts Differences," and apply this debit of 316

C.H. points 370 @ $5.00	$	1850	Customers' net points		
			316 @ $5.00	$	1580 -
			Balance		270 -
		1850 -			1850
Balance to offset					
account #1 - (proof)	$	270			
Account #2					

Form 23. Dummy Ledger Account and Contract Differences Account

points to the credit side of the dummy. Resolved into terms of money, this is equivalent to $1,580.

5. This step deals with the working up of the figures of the clearing house division. On the purchase side, the clearing house sheet as of January 30 contains the following open contracts at the settling price of that day. On the long side the sheet reveals as open contracts carried with the association and which must be reduced to points:

500 March	at 31.00	equals	15,500	points
300 October	" 30.40	"	9,120	"
Total			24,620	"

6. The short contracts carried with the clearing house are:

300 July	at 30.50	equals	9,150	points
500 December	" 30.20	"	15,100	"
Total			24,250	"

7. Deduct the lesser number of points from the greater, thus: 24,620 minus 24,250 equals 370 points debit, which reduced to terms of money, equals $1,850.

8. Apply this $1,850 to the debit side of the Contract Differences "dummy." This account now contains a debit of $1,850 and a credit of $1,580, or a debit balance of $270, the amount sufficient to liquidate the liability in the Contract Differences account. This balance verifies all open commitments with the clearing house division and in the customers accounts, both as to quantity and prices. It also proves the correctness of the work for the month in so far as the accuracy of debits and credits to customers in connection with their closed transactions is concerned, and also proves that payments made to or received from the clearing house were correct.

Theory of the Point Balance

It was stated before, as a general proposition, that the Contract Differences account was only a temporary or clearing

account which existed on the broker's books either as an asset or as a liability, depending entirely upon the outcome of customers closed commitments and of the advance payments to the clearing house or receipts from the clearing house. It was further stated that if all transactions were liquidated the Contract Differences account would cease to exist, as on the one hand it would contain a history of the losses of customers offset by payments to the clearing association, and on the other hand it would contain the profits of the customers offset by receipts of cash from the clearing house. Referring to the dummy account, it will be found that if the debit of $270 is applied to the real Contract Differences account a liquidated condition will be shown.

The proof of the point balance, therefore, is simple enough to comprehend if we proceed upon the theory that when open contracts of customers are closed at prices equal to the last clearing association settling prices, and the liquidation of open contracts in the clearing house, long or short, is made on the basis of these last settling prices, contract differences cease to exist.

CHAPTER XXII

SETTLEMENT BY DELIVERY OF COTTON

Typical Transactions

The typical transactions of a cotton brokerage business most frequently encountered are:

1. Direct purchases
2. Direct sales
3. Hedging
4. Speculation
5. Straddles

1. *Direct Purchases.* Direct purchases by mills and spot merchants presuppose that the delivery of and payment for actual cotton are made in satisfaction of previously held options.

Mill operators seldom enter the futures market for the purpose of demanding actual delivery on contract, since they are able to satisfy all their needs by purchases in the spot market. However, the spot markets may be demoralized, and the operators then resort to the futures market.

The spot merchant, on the other hand, uses the futures market for most of his business. He sells to the mill and immediately buys that option month in which he is expected to make delivery to the mill. Before the option becomes due, he may buy the cotton in the spot market and sell his futures. With the spots so purchased, he can then fill his mill contracts.

2. *Direct Sales.* Direct sales by the planter contemplate the actual shipment of cotton and immediate payment by the purchaser. Suppose a cotton grower sells his cotton on a New York contract. After the samples are classified, the cotton is sent on to a licensed warehouse, weighed, and com-

pared with the sample. The buyer comes into possession of the warehouse receipts and makes payment to the planter or his Cotton Exchange representative. This subject is treated more fully later in the chapter in connection with spot market transactions.

3. *Hedging.* The hedging method of trading may be used by planter, spot merchant, mill, or speculator. The planter seeks to protect himself against damages resulting from his inability to make delivery against his sale, such inability possibly being caused by a failing crop. Again, he may have sold his product at a stated price, long before the cotton was in actual existence. Then, when his crop is realized, if there is a small supply throughout the country, the price of cotton may have risen 100 points. In that case, unless the planter has purchased futures against his contracted sale and thus protected himself, he will have lost to the extent of this price advance.

The spot merchant, as already stated, uses the hedging plan much in the same manner as does the planter. The speculator and the mill hedge in order to escape additional loss on long contracts in a declining market and on short commitments in a rising market.

4. *Speculation.* Many traders make a close study of crop conditions and then speculate in futures on the basis of the information they acquire. Speculation in cotton futures is as prevalent as speculation in stocks. However, more factors enter into the price-making of cotton and other commodities than of stocks. Security values for the most part rise and fall on the basis of strength or weakness in earnings. The commodity markets, on the other hand, are so sensitive to financial, economic, and general commercial conditions that a close study of all these conditions is essential to understanding or operating successfully in the futures market. A study of price-making involves so many technicalities and is so

broad that the subject of speculation cannot be treated in detail here.

5. *Straddles.* Another method of trading is known as the "straddle." Invariably all contracts approaching the day of expiration sell either at a premium over other months or at a discount. Where the demand for immediate use is very large, the cotton which is most quickly deliverable will command the highest price, and as between March and May, March, which is the first expiring month, may sell at a premium over May. If the supply is extremely large, March contracts may sell below the price for May. For example, the operator who makes a study of supply and demand conditions may purchase 500 March at 30 cents and sell 500 May at 29.82 cents. This trade is made at a difference of 18 points between March and May. As the due date arrives for March delivery, the demand may be small and the price may drop so that the difference between the two months is 65 points. If now the 500 March are sold and the 500 May are bought in, a gross profit of $1,175 will be made. A transaction of this sort is known as a "straddle."

Notice of Delivery

All purchases, whether they are direct, hedged, or straddled, are passed through the books in the customary way. When the option month in which the contract has been made nears the point of expiration, the direct purchasers, such as the mill and the spot merchant, want the actual receipt of the commodity. The hedger and the straddler make known their intentions to their brokers before the latter receive a Notice of Delivery which reads to the effect that the person issuing the notice is ready and willing to deliver the number of bales of cotton called for by the contract.

Considering the first class of customers—the mill and the spot merchant—the notice, when issued to the buyer, is

"stopped." This means that the person "stopping" the notice thereby signifies his intention to receive the cotton at the price which is set by the Exchange to operate as the notice price. The issuing broker, according to the tenor of the notice, indicates his intention to deliver to the person who "stops" the notice.

Clearing Association as Intermediary

As all contracts entered into on the New York Cotton Exchange are cleared by the association, the subject of issuing notices for the delivery of cotton becomes somewhat complicated. It should be remembered that contracts for the sale of cotton are offset by contracts for the purchase of cotton. If the clearing house sheets of the respective members are recapitulated, it will be found that for every sale there is a purchase—for every long there is a corresponding short. Consequently, it may be that brokers who are "short" through the clearing house will be delegated by their customers to deliver the actual cotton in satisfaction of the sale. Conversely, those who are "long" may be instructed by their customers to receive the cotton against the purchase. Upon the day of delivery, the broker desirous of delivering cotton issues a notice to the clearing house, which in turn directs the notice to be delivered to a broker long of a similar quantity of the same option. If the latter broker has been instructed not to receive the actual cotton, he at once gives orders for the sale of the customer's holdings. The sale is made to a third broker, who immediately receives the notice from the second broker. This process is repeated until finally a broker is found who has orders from his customer to receive actual cotton. The notice then stops circulating. The last-named party eventually receives a warehouse certificate upon payment of the amount involved. This payment consummates the transaction.

Adjustment Between Purchase and Notice Prices

As before stated, the Exchange sets a price at which cotton shall be delivered upon notice. This delivery price may be at variance with the purchase price in the customer's account. If we assume that this notice price is 31 cents, the question arises as to how the difference between the purchase price and the notice price is adjusted. In the foregoing example, let us assume that 100 January were purchased through Adams, Burns and Conant at 30.10 cents, which, reduced to dollars, is equivalent to $15,050. In their account with the clearing association the purchase price appeared as 30.10 cents. After the notice was delivered to Adams, Burns and Conant, an offset was made in the account to show the delivery through the clearing house. While Adams, Burns and Conant, the direct purchasers, were called upon to pay $15,500, instead of $15,050, they received the difference of $450 from the broker with whom the original commitment was made through the clearing house. That is, Adams, Burns and Conant received a draft from the clearing house for the difference between the last clearing house settling price for January and the notice price. But between the time of stopping the notice and of receiving the warehouse receipt other items entered into this spot transaction, such as storage, insurance, labor, and sometimes freight charges. All these incidental expenses were charged to the customer.

Sales for Actual Delivery

Let us now consider how a sale for actual delivery is handled. Suppose a planter wishes to sell his output. In accordance with the grading rules of the Cotton Exchange and the Department of Agriculture of the United States, he can sell only a classified standard grade of cotton. Assuming that his product comes within the classification, he sells through some broker in New York or New Orleans. Upon

the first notice day, the broker issues a "notice." According to the rules, he must deliver the number of bales called for. Each notice is issued for the delivery of 100 bales. The cotton is subsequently shipped, inspected, and graded. If it comes within the prescribed classification, the contract is settled by payment as heretofore described.

Expiration of Options

Turning for a moment to hedged, straddled, and long transactions, we find that customers who are carrying the long side of an option approaching expiration invariably sell as soon as the notice is tendered. The broker to whom the contracts are sold is the person to whom the notice is immediately transferred through the medium of the clearing association and the deal is consummated.

Customers who are short of an option the expiration of which is nearly due usually "cover" or buy in the shortage in order to escape the liability of actual delivery. On long contracts the options must be disposed of as soon as the notice is tendered. On short contracts, however, the seller may remain short of his contract until the last notice day. There are several notice days during the current month. Transactions are usually carried on up to 12 o'clock noon of the last day of the month, Sundays excepted. Ten minutes is the time allowed for the transferring of such last-day notices. This is technically known as a "short notice."

Broker's Net Interest

A condition might exist where one customer is long and another short of the same option month. From the broker's point of view he may have no contracts in the clearing association, i.e., his net interest is nil. However, from the customer's standpoint, one would still be long and the other short of the month in question, but unless actual receipt and

delivery is intended, one customer will be compelled to buy in against his short and the other to sell his long on or before the last notice day. If the "short" customer covers before this time, the receipt of a notice of delivery will compel the sale of the long contract immediately.

Branch Offices

The vast majority of cotton brokerage concerns maintain branch offices throughout the South. This is done in order to obtain advices concerning crop conditions and to procure southern business.

Solicitors

According to the rules of the Exchange, no member concern may enter into a contract of employment between itself and solicitors for a period of less than one year. In most cases the renewal of such contracts depends upon the amount of business produced by the solicitors.

In order to keep account of the amount of business brought in by the solicitors a production record is employed. This record gives the number of bales during a day, week, month, and year, and the commissions resulting from the business secured by the solicitors. Opposed to the production figures are the factors of expense, including solicitors' salaries, traveling expenses, and rent for branch offices. Deducting the total expenses of a solicitor from his production figures gives the margin of profit for that solicitor. The commissions are figured for each 100 bales.

Each day's record of purchases and sales is analyzed for the purpose of allocating the respective units in the proper solicitors columns. The production record contains also a record of the business resulting from the "local" activities of partners. Thus a complete report of the broker's volume of business is herein contained.

Floor Brokerage Business

Many Exchange members make a practice of executing orders for other brokers at a nominal charge for each 100 bales bought or sold. At the end of each month a bill is rendered which, when paid, is credited to an account known as "Floor Commissions Received."

Clearances

When a broker has bought and sold an option for his personal account and does not desire to carry the contracts until settled, he may ask another concern to clear for him. Clearances can be compared to the ordinary purchase and sale for the account of a customer. The commission charged on such transactions varies with the market prices. The usual account sales is rendered, and the commission is credited in the regular way. At the end of the month, however, such items are segregated by means of a summary and credited to an account known as "Clearance Commissions."

Carrying Transactions

Another source of income in the cotton brokerage business is derived through the carrying of transactions for other members of the Exchange. A number of the brokers speculate in the market for their own account. They seldom carry their own contracts, usually asking some other concern to carry their commitments. When these accounts are subsequently closed, one-half the usual commission is charged by the carrying broker on both the purchase and the sale. Here, again, an account sales is rendered and the brokerage earned is credited to the Commission account.

Half-Commission Brokerage

Many of the member firms neither clear nor carry the commitments of their customers. There are various reasons

for this. It is sometimes due to the fact that there is a reluctance to tie up money unnecessarily in clearing house margins on which only a comparatively small rate of interest is received from the banking institutions in which the margins are deposited.

In such cases, by arrangement with another concern, the first concern can conduct its business on a half-commission basis. If, for example, the charge to the customer is $30 for the purchase and sale of a contract, the brokerage concern is only charged $15 by the carrying house for every 100 bales bought and sold, that is, $7.50 on the purchase and a like amount on the sale.

Under such circumstances no clearing house records are kept by the half-commission broker, for the need for such records is never present. Nor is there any necessity for his keeping a Contract Differences account, as this phase of the business is the problem of the "carrying" house. For example, customer A, whose broker is operating on the half-commission basis, buys 100 January at 30.10 cents and sells 100 January at 29.90 cents, thereby losing 20 points, or $100. Adding the commission of $30, his total loss is $130. A's broker instructs the carrying house to apply or close out 100 January bought at 30.10 cents against the sale at 29.90 cents. As far as contract differences are concerned, there are none on the books of A's broker. However, assuming for the moment that such an account is in operation, then the credit to the account is $100, but the amount is immediately offset by a charge to it and a credit to the carrying broker.

The question may properly be asked: How is the entry made on the books of A's broker? It is made through the medium of the general journal, as follows:

Debit Customer A	$130.00
Credit Carrying Broker	115.00
Credit Commission	15.00

An account sales is rendered to the customer, but it acts only as material for the journal entry. As may be inferred, no analysis journal is necessary for such transactions.

Technicalities of the Spot Market

In discussing cotton brokerage accounting from the standpoint of the futures market we have seen that for the most part settlement among the brokers is made by means of the "differences" system. That is, the actual receipt and delivery in satisfaction of the options bought and sold are seldom availed of, but in most cases contracts are closed by means of clearing house settlements long before these contracts expire. To such an extent is this carried as to create the erroneous impression that speculation alone is the motive prompting such transactions.

Although in spot market transactions very little actual accounting is required as compared with purchases and sales in the futures market, there is probably nothing else in the brokerage business so involved in technicalities. The system employed in "taking up" a contract, or making delivery against an option sold, is so different from anything found in general business as to deserve further treatment in its accounting phase.

Details of Actual Delivery

The intention to take up a cotton contract is indicated by the stoppage of the notice. The last holder is charged with the duty of informing the broker issuing such document that the former has in his possession the notice in question and makes demand for the delivery of the cotton within two days from the date of the issued notice. This is done by means of a written "demand" which is stamped by the superintendent of the Exchange and delivered to the broker upon whom the demand is made. The new contractual relations between the

brokers in the transaction are now officially recognized by the Cotton Exchange.

As an illustration of the foregoing, let us assume that a purchase of 100 bales of December cotton is made in May at 30.10 cents. When the notice day arrives, if the buyer intends assuming the contract, he goes through the stoppage of notice formalities just described; and upon the third day from the date of notice, he receives from the seller for examination documents known as "grade certificates" and also a "spot bill."

Each grade certificate states the number of bales it represents, the markings for identification purposes, where the cotton is stored, when inspected by the Exchange authorities, when the certificates expire, and the grades of cotton in each case. This grade certificate is a document issued by the Classification Bureau of the Exchange.

The spot bill contains a full statement of charges and allowances covering the "weight price." It also states the cost for inspection, classification, certification, and storage. Allowances for grade, weight, and storage of cotton are items which must be studied independently if they are to be thoroughly understood and applied in practice.

On the third day after notice, warehouse certificates covering the actual commodity are delivered and the cotton is paid for. This terminates the contractual relationship between the brokers involved in the transaction.

Limits of a Cotton Contract

According to the rules of the New York Cotton Exchange, a contract weighing between 49,500 and 50,500 pounds must be received in fulfilment of a transaction. So long as the weight is within these prescribed limits, no importance is attached to the number of bales involved. Thus, instead of containing 100 bales, a contract might run from 4 to 8

bales over or under that number. If 92, 108, or some other number of bales make up the necessary weight, they are a good delivery.

The laws of the Exchange provide that an allowance of ½ pound per bale for each month or fraction of a month be made to the buyer, from the time cotton is stored until the date of transfer.

Let us assume that warehouse certificates show that 92 bales of cotton, covered by such certificates and weighing 49,838 pounds, are in the Manhattan Stores on May 26, 1919. If this cotton is transferred on contract on December 31 of the same year, there will be an allowance in weight for seven full months and a fraction, making, under the rules of the Exchange, a total of eight months. Allowing ½ pound per bale per month for that period on 92 bales, the weight allowance will be 368 pounds. If this is deducted from the gross weight of 49,838 pounds, the net weight is 49,470 pounds.

Cost of Contract

Continuing the same transaction, the next point for consideration is the original cost of the contract. Multiplying the net weight by the notice price of 30.40 cents gives $15,038.88. Added to the original cost is the standard charge of 12½ cents per bale for inspection, classification, and grading certificates. No matter how often the cotton is transferred from one buyer to another, these charges obtain. On 92 bales these incidental charges are $11.50, making a total cost of $15,050.38.

Grades of Cotton

Under the rules of the New York Cotton Exchange, only specified grades of cotton may be delivered on contract. The following grades are admitted by the Classification Committee:

Above Middling	Below Middling
Middling fair	Strict low middling
Strict good middling	Low middling
Good middling	Strict good middling—yellow tinged
Strict middling	Good ordinary
Middling	

Other grades may be made the subject of contract it agreed upon.

Grade Premium and Discount

The basis for all grades is middling cotton. All graded above middling command a premium or an addition to the stated selling price by reason of the superior cotton represented by these grades. On grades below middling an allowance is made on account of the inferior quality of the cotton. Each grade, except middling, commands a certain number of points, premium or discount.

Reverting to the 92 bales of cotton stored on May 26, 1919, let it be assumed that the delivery was as follows: 1 middling, 7 strict low middling, 12 low middling, 48 strict good middling—yellow tinged, and 24 good ordinary. All these grades, except the middling, were below that basis, and were therefore subject to a discount. On the 1 bale of middling the rate was "flat," meaning no discount or premium; on the 7 strict low middling the discount was .5 cents a pound, or a total of 3.5 cents; on the 12 low middling the discount was .85 cents a pound, making an allowance of 10.2 cents; on 48 strict good middling—yellow tinged, at 1.25 cents discount, the allowance was 6 cents; on 24 good ordinary at 2 cents discount the allowance was 48 cents. The grand total was $1.217. If we multiply the allowance of $1.217 by the net weight of 49,470 pounds (that being the poundage to be considered) and divide the product of $60,204.99 by 92 (the number of bales contained in the con-

tract), we obtain the result of $654.40, which was the allowance made for the inferior grades.

Storage and Labor

The charge for storage and labor in connection with the warehousing of cotton is sometimes paid by the seller to the storage company up to the time of the sale. In the great majority of cases, however, the storage and labor charge is allowed to accumulate and is deducted by the seller from his spot bill to the buyer. The charge for storage is 20 cents a bale for each month, and 10 cents a bale for half months. The cost for labor is 10 cents "in" and 10 cents "out"; that is, 20 cents for putting the cotton in storage and taking it out. The "out" storage charge is paid by the buyer when he releases his cotton from store, while the "in" storage is allowed by the seller. In the case of the cotton stored May 26, 1919, the storage and labor were paid by the seller up to May 26, 1919. From that date until December 31, 1919, there were seven full months of storage at 20 cents, and one half month at 10 cents, or $1.50 for each bale. On 92 bales, therefore, the storage allowance was $138.

The total charges on this transaction were $15,050.38, and the total allowances for grade, storage, and labor were $792.40. Therefore the net cost of the contract to the customer was $14,257.98.

Insurance and Interest Charges

There are other minor charges made against the customer's account in connection with the spot cotton transactions. Some of these charges are in the nature of insurance and interest. A small charge is also made for the storage of cotton samples, which are supplied by the broker delivering the cotton against the spot transaction. The addition of these charges consummates the deal.

The Spot Register

All the facts pertaining to spot cotton transactions find suitable expression in the "spot register," so arranged as to show at a glance all details in connection with the purchase and subsequent disposition of cotton, either by delivery against a futures sale or by direct shipment to the consumer.

CHAPTER XXIII

CLOSING COTTON BROKERAGE BOOKS

Adjusting Entries

Before closing the books of a cotton brokerage house a number of adjustments are necessary. The most common ones are:

1. Provision for reserve for depreciation on furniture and fixtures.

2. Provision for reserve for doubtful accounts receivable.

3. Provision for doubtful and uncollectible accounts receivable written off.

4. Provision for accruals of:

   (a) Interest on:
      (1) Clearing house margins unreleased
      (2) Notes receivable
      (3) Notes payable
   (b) Rent
   (c) Office salaries

5. If securities be held for investment purposes suitable provision should be made for any depreciation in market values.

6. All items under floor brokerage receivable or payable should be evidenced by the books, so that a proper accounting may be made of the earnings or expense connected with such brokerage.

7. In businesses which are conducted on a cash basis the usual tendency is to overlook items of expense for which no bills have been received. To avoid an overstatement of profits due to an understatement of expenses, suitable pro-

vision should be made for such items as bills due and unpaid, and estimated traveling expenses.

Income and Expense Factors

The sources of income in the cotton brokerage business and the general expense factors incident to the operation of the business, including both main office and branch offices, are as follows:

Income Factors

1. Commissions (from all sources)
2. Interest on notes receivable
3. Interest on clearing house margins
4. Interest on bank balances
5. Dividends and interest on investment securities

Expense Factors

1. Rent of offices
2. Salaries
3. Advertising
4. Telegraph
5. Telephone
6. Ticker service
7. Market reports and bulletins
8. Postage
9. Stationery and printing
10. Legal services
11. Collection on out-of-town checks
12. Traveling expenses
13. Entertainment

The Financial Statement

I. *Statement of Income from Operation.* The main source of income from the operation of the cotton brokerage business are the commissions derived from the various sources already explained.

II. *Administrative Expense.*

1. Rent of offices
2. Salaries
3. Advertising
4. Telegraph
5. Telephone
6. Ticker service
7. Market reports and bulletins
8. Postage
9. Stationery and printing
10. Legal expense
11. Collection on out-of-town checks

III. *Branch Office and Solicitors' Expense*

1. Branch office rent
2. Agents' and solicitors' salaries
3. Traveling expense
4. Entertainment expense

IV. *Net Income from Operation.* The net income from operation is determined by deducting the total expense from the income, i.e., I less (II plus III), or, I less II less III.

V. *Secondary Income.* Aside from commissions, which are the main source of income, the following four items may be considered as secondary income:

1. Interest on notes receivable
2. Interest on clearing house margins
3. Interest on bank balances
4. Interest or dividends on securities

VI. *Income from All Sources.* This is derived by adding the net income from operation and the secondary income, i.e., IV plus V, which is the same as, I less II less III plus V.

VII. *Deductions from Income.* There are two items of expense which must be deducted from the income in order to obtain the net income, viz.:

1. Interest on notes payable
2. Exchange on out-of-town checks

VIII. *Net Income.* If the total of "Deductions from Income" is taken from "Income from All Sources" the result is the net income, which may be written thus: I less II less III plus V less VII, or, (I plus V) less (II plus III plus VII).

IX. *Profit and Loss Charges.* Under this heading appear the following:

1. Loss on uncollectible accounts
2. Loss on the sale of securities held for investment
3. Provision for reserve for depreciation of furniture and fixtures
4. Provision for reserve for doubtful accounts receivable
5. Provision for reserve for sundry expenses
6. Provision for reserve for traveling expenses

X. *Profit and Loss Credits.* The following are included under this heading:

1. Recovery on doubtful accounts receivable
2. Profit on sale of securities held as investment

XI. *Profit and Loss.* Deduct the profit and loss charges (IX) from the profit and loss credits (X), or deduct X from IX, as the case may be, and the net profit and loss debit or credit is the resultant. Applying the net profit and loss debit or credit (XI) to the net income (VIII) (adding in case of a credit and subtracting in case of a debit), the net surplus for the accounting period is determined.

The distribution of this surplus, according to the articles of copartnership, is the final operation in closing the books.

The Balance Sheet—Assets

Capital Assets. The only items which ordinarily appear as capital assets are:

1. Furniture and fixtures
2. Securities held for investment
3. Membership on Exchange
4. Clearing association membership

Current Assets. Under this heading are the following items:

1. Cash on hand and at banks
2. Accounts receivable—considered good
3. Clearing house margins
4. Notes receivable
5. Accrued interest on clearing house margins
6. Accrued interest on notes receivable
7. Contract differences (this may also appear as a liability)

Deferred Debits. Under the heading of deferred debits may be listed the following items:

1. Rent paid in advance
2. Membership dues paid in advance
3. Insurance paid in advance (on spot transactions)
4. Telephone privilege on New York Cotton Exchange, paid in advance

Liabilities

Capital Liabilities. In the cotton brokerage business capital liabilities are seldom found. For the most part all the debits of the concern are current in nature. The usual liability and proprietorship items may be listed under the two headings, "Current Liabilities" and "Proprietorship," as shown below.

Current Liabilities:

1. Customers' accounts payable
2. Notes payable
3. Interest accrued on notes payable

4. Salaries accrued
5. Contract differences (this may also appear as an asset)

Proprietorship:

Reserves:

1. Reserve for depreciation on furniture and fixtures
2. Reserve for depreciation on security investments
3. Reserve for traveling expenses
4. Reserve for other expenses for which no invoices have been received

Capital:

1. Partner Adams' capital
2. Partner Burns's capital
3. Partner Conant's capital

Table of Equities

In discussing the liability item "Customers' accounts payable," reference must be made to the table of equities treated in Chapter XVI. The fact that a customer's account shows a credit balance of $1,000 is no indication that such an amount is owing to him. What must be considered is the loss or gain reflected in his open contracts. The balance sheet should never be read without reference to this table.

The listing of all assets and liabilities in a table of equities is less urgent in cotton brokerage than in the stock brokerage business. In cotton brokerage it is sufficient to compile a statement of margins for the sole purpose of determining the respective conditions of the customers' accounts.

Dissolution

Both the voluntary and involuntary dissolution of a stock brokerage business were treated in a general way in Part I,

and that discussion applies to cotton brokerage as well. It may be said, however, that the customers' interests are not as well guarded in the case of a forced dissolution of a cotton brokerage house as in the failure of a stock brokerage house. In the latter case the customers have their securities to fall back upon, while in the cotton business the only realizable asset is their equity in the membership seat, worth approximately $25,000.

PART III

PRODUCE BROKERAGE

CHAPTER XXIV

NEW YORK COMMODITY EXCHANGES

Scope of Discussion

In this chapter such transactions are discussed as enter into the daily business of the New York Produce Exchange and the New York Coffee and Sugar Exchange.

Here, as in the cotton business, two markets exist—one in which spot or cash transactions appear, and the other where the dealings are in future contracts. Since by far the majority of all trades are entered into for future account, it is superfluous to treat the spot market at any length. That branch of the subject can be disposed of with the summary remark that there is a close resemblance in the methods of receiving and delivering coffee, sugar, oil, and grain spots, and that of consummating spot transactions in cotton. Hence, the discussion deals largely with the accounting of future contracts between members.

Cottonseed-Oil Brokerage

While the New York Produce Exchange trades in grain futures, its dealings are principally in cottonseed-oil futures. According to the rules of the Exchange, contracts may be traded in between members for the purchase and sale of cottonseed-oil in units of 100 barrels and multiples thereof. Contracts may call for the receipt and delivery of oil for various periods during the year. They may be assigned to a third party through the medium of sale or transfer.

Much in the same manner as cotton futures are used for the purpose of hedging actual cotton, so may the oil market be used to protect the interests of producer and consumer.

A contract (100 barrels) when purchased carries the right to demand, or, when sold, the right to deliver 40,000 pounds of prime summer yellow oil at the price specified in the contract.

The prices are quoted on the Exchange in cents and hundredths of a cent per pound, the latter being known as points. Thus, a point fluctuation equals $4 per contract.

The commission charge to non-members is $25 for the combined purchase and sale of each contract.

For the purpose of expediting the settlement of transferred or assigned contracts a clearing house was organized by the members of the Exchange. Its methods being identical with those of the New York Cotton Exchange, little need be said concerning it. In 1914, the Cotton Exchange copied the system of clearance in vogue for many years on the Produce Exchange.

Coffee Brokerage

A contract in coffee entitles the purchaser, if he demands the specific performance of it, to approximately 250 bags of graded coffee, weighing 32,500 pounds. These contracts are transferable through sale or assignment, and the difference between the purchase price and the sales price measures the profit realized or the loss sustained.

The price is quoted in cents and hundredths of a cent per pound, a fluctuation of .0001 cent equaling $3.25 per contract.

The commission to non-members is $10 for purchasing and $10 for selling one contract, making a total charge of $20 for the closed transaction.

The margin requirements are fixed by the broker, largely according to the state of the market. When coffee sells at 20 cents a pound, the margin demanded is greater than when coffee sells at 7 cents. The minimum seems to be set at $500 per contract.

Sugar Brokerage

A few years ago the idea of establishing a sugar market occurred to the members of the Coffee Exchange, and the result has been the inauguration of a free market for the purchase and sale of sugar futures.

The sugar contract dealt in on the Exchange covers the receipt or delivery of 50 tons of raw sugar, weighing approximately 112,000 pounds. The price fluctuations are quoted in cents and hundredths of a cent per pound, a fluctuation of .0001 cent equaling $11.20 per contract.

Commission for the combined buying and selling of one contract depends upon the price prevailing at the time. The following table gives the scale of charges:

Below 4 cents per lb.	$25.00
4 cents to 9.99 cents	30.00
10 cents to 12.99 cents	35.00
13 cents to 17.99 cents	40.00
18 cents and above	50.00

Coffee and Sugar Clearing House System

With the object of compelling members to adjust their differences through a clearing house, the same form of settlement as exists on the Cotton and Produce Exchanges has been adopted. Since the clearance of coffee and sugar contracts are under the jurisdiction of a common clearing organization, two sheets are filed daily by those members who have both coffee and sugar transactions to clear. However, instead of carrying out into the value column so many dollars, only point differences are extended. After totaling up all the points, the net difference, debit or credit, is multiplied by $3.25 in the case of coffee contracts, and by $11.20 in the case of sugar contracts. A brown sheet is used for coffee trades and a white sheet for sugar contracts.

A supplementary statement is then used for the purpose

of recapitulating the coffee and sugar sheets as to money balances owed to or claimed from the clearing association. The supplementary statement also provides for the reconciliation of the original margins required on each class of transaction. Hence, instead of issuing two checks or two drafts for market differences, only one is necessary. Similarly, only one check is drawn for the margin required by the association. If a surplus margin is on deposit for coffee contracts, this surplus can be applied to any deficit in margins on sugar trades, and vice versa.

The original margins demanded by the association are:

(a) Upon a net interest of 500 contracts of coffee, or less, ... $250 per contract.

(b) Upon a net interest exceeding 500 contracts and not over 1,000 contracts of coffee, $500 per contract upon such excess.

(bb) Upon a net interest exceeding 1,000 contracts of coffee, $750 per contract upon such excess.

(c) Upon a net interest of 500 contracts of sugar, or less, $400 per contract.

(d) Upon a net interest exceeding 500 contracts, and not over 1,000 contracts, of sugar, $500 per contract upon such excess.

(e) Upon a net interest exceeding 1,000 contracts of sugar, $750 per contract upon such excess.

The rules of the association provide:

> The Directors may at any time upon twenty-four hours' previous notice, in writing, to be delivered at the offices of all clearing members, require that an original margin per contract of coffee or sugar, in such amount as the Directors may deem desirable, be maintained upon the net interest of members in their contracts with the Association. This requirement shall remain in effect until withdrawn by the Directors. . . . .
>
> No clearing member shall be allowed to have contracts with the Association representing a net interest of more than 2,500 contracts of coffee or 2,000 contracts of sugar.

Books of Account

The following books will be most commonly found in the broker's office to record transactions made in oil, coffee, and sugar for future delivery:

Purchases and sales book
Customers margin book
Customers contract book
Analysis journal
Customers ledger
General journal
Cash book
General ledger

The ruling, arrangement, and the uses to which these records are put are identical in every respect with those of the corresponding books used in the cotton business.

CHAPTER XXV

CHICAGO BOARD OF TRADE

Commodities Traded In[1]

Many Wall Street concerns have memberships on the Chicago Board of Trade. By being so affiliated, they may send orders to their Chicago correspondents for execution and earn one-half the usual commission. Thus, without incurring any of the expense of clearing their own purchases and sales, they receive additional income.

The following commodities are listed for active trading on the Chicago Board: (1) grain, comprising corn, wheat, oats, rye; (2) provisions, comprising pork, ribs, and lard.

A cash market and a futures market are operated. Most of the business which is directed to Chicago by New York brokers falls under the second division, namely, that of the futures market.

The Grain Market

The methods of trading on the Chicago Board of Trade are very similar to those in vogue on the New York Exchanges. Wheat, oats, corn, and rye are bought and sold by contracts. Each contract contains 10,000 bushels. The price is quoted in cents and fractions of a cent, ranging from one-eighth to seven-eighths. A fluctuation of one-eighth is equivalent to $12.50 on each contract.

The commission charged on a purchase and sale combined is $25 for each contract of wheat, corn, rye, or oats.

---

[1] For the rules and regulations of the Chicago Board of Trade see AppendixE.

Provisions

The purchase or sale of 250 barrels of pork is one contract, the price being quoted in so many dollars and cents per barrel. The fluctuations are 2½ cents apart. To illustrate, assume the purchase of 250 barrels of pork at $19.50. The next variation would be either $19.47½ or $19.52½. In the upward trend, the fluctuation would range as follows: $19.50, $19.52½, $19.55, $19.57½, $19.60, etc. Each variation is equivalent to $6.25. The commission is $10 on the purchase and $10 on the sale—a total brokerage of $20.

A contract in ribs equals 50,000 pounds. The price is quoted in cents and hundredths of a cent per pound. As the fluctuations are 2½ points, each change in price is equivalent to $12.50. The commission is $20 on the "round" transaction.

Each contract in lard contains 250 tierces, each tierce weighing approximately 340 pounds, or 85,000 pounds in the contract. The price is quoted in cents and hundredths of a cent per pound. The fluctuations are of the range of 2½ points, or $21.25 on one contract. The commission charge is $20.

Chicago Trades on Books of New York Members

No books of account other than those kept for the general business are necessary to record the New York broker's Chicago transactions. To illustrate, suppose Adams, Burns and Conant, members of the Chicago Board of Trade, direct their orders in Chicago futures through Long and Barnett of Chicago. The latter concern attends to the clearing of the contracts, the margins, and settlements. In other words, they carry the commitments until finally closed.

A page similar to that used for recording customers' purchases and sales in cotton will answer the purpose of recording all transactions in Chicago futures contracted for by New York customers. Thus, if customer A purchases 10,000

bushels of Chicago May corn at $1.75, the transaction is entered in the column under A's contract folio headed "May Corn, Chicago," in the same manner as in cotton accounting. To evidence the purchase through the Chicago brokers, a column under Long and Barnett's "Our Account"—contract page—reflects the transaction. In effect it is made to appear that Long and Barnett are long of 10,000 May corn at $1.75, but the item should be read "We are long with the firm of Long and Barnett."

When the customer sells, an account sales is rendered showing the gain or the loss, and the result is journalized. The general journal is more commonly used in connection with such entries.

Assume that A sells the corn for $1.77 a bushel and makes a gross profit of $200. The entry for this transaction appears as follows:

Debit Long and Barnett..........	$187.50
Credit Customer A..............	175.00
Credit Grain Commission........	12.50

A statement of the trade is received from Long and Barnett attesting to the settlement, and on the Long and Barnett "Our Account" page the sale is shown as though it had been made for them.

The same procedure is followed in other grain and provision settlements.

No point balance is necessary, owing to the fact that the unliquidated contracts carried by the resident broker are confirmed at the close of each month, showing the quantity and price of all open commitments. The accuracy of the settled options is verified by the account sales received during the period.

The commission realized from Chicago business is included under income from operation.

Books of the Chicago Broker—Conditions Affecting Entries

In all future business, contracts may be sold short and eventually covered, or they may be sold for actual delivery. In the latter case, the grower may ship his grain or provisions in satisfaction of his sale contract. On the other hand, the produce may be purchased with the object of making a speculative transaction for a profit.

In recording the purchase or sale of contracts for customers options are entered in a contract book, and when they are consummated, an account sales is rendered to the customer showing the loss or gain on the transaction. The fact that the purchase might have been made by his broker from broker B, and the sales to broker C, is of little interest to the customer. He is interested principally in the fact that his account was properly charged with the loss, or credited with the profit realized. To him the contract is a closed one. But the contract is not necessarily closed so far as his broker is concerned.

Assume that A buys 100,000 bushels of May wheat from B for the account of Jones. When Jones gives his selling order, the 100,000 bushels of May wheat may be sold to C. This example illustrates two points:

1. That open contracts can exist with other brokers without having a corresponding interest in the market for the account of one's customers. In the case just cited, A had no interest in the market for the account of Jones; yet his books, containing the record of contracts made with other brokers, reflect a condition totally at variance with the fact that contracts are still open with brokers B and C.

2. That the broker's Street books—those books of accounts in which are entered the contractual relationships of A with other brokers, and their final settlement—are apparently kept in total disregard of customers' accounts.

From this it might be inferred that settlements of closed contracts for customers and with brokers cannot be simulta-

neous. Hence the question arises: What system is employed by the Exchange to make possible the closing of contracts between brokers, except by specific performance? In other words, how can A who has purchased and sold for Jones 100,000 bushels of May wheat settle his commitments with B, from whom he has bought, and with C, to whom he has sold? Will he have to wait until the wheat is tendered by B at the purchase price and then retender it to C at the sales price to reimburse himself for the money advanced to Jones?

Methods of Settlement

Omitting the method known as "delivery settlement," which entails the delivery of the produce to the buyer, there are, generally speaking, only two methods employed in settling outstanding contracts between brokers: (1) direct settlement, and (2) ring settlement.

1. *Direct Settlement.* The method of settling contracts between brokers by way of direct offset, by either purchase or sale, is so obvious as to require very little elaboration. Suppose A buys from B, on April 10, 50,000 bushels of May wheat at $1.90, and on April 15 sells to B the same quantity at $2.10 per bushel. Thus B owes A the difference between the purchase price and the sales price, as shown below:

Sold 50,000 bushels May wheat at $2.10....	$105,000
Bought 50,000 " " " " 1.90....	95,000
Difference B owes A....................	$10,000

The following is another example: A sells to B, on April 10, 50,000 bushels of May wheat at $1.90, and on April 15 buys from B 50,000 bushels of the same delivery at $2. A settles by paying B $5,000—the difference between the two transactions. The coincidence of having bought from and sold to B makes it possible for A to effect a direct settlement with his fellow-broker.

2. *Ring Settlement.* This method is an indirect means of settling contracts. By the term "ring settlement," or "ringing," is meant the matching of buyers against sellers of the same options, or contracts, for the purpose of literally "getting out" of the contract and thus effecting a settlement through an assignment of the buyer's or seller's rights to others seeking similar assignments. If A owes B $100 and B owes C $100, B can, by assigning his rights against A, settle with C. Bearing in mind this fundamental principle in the actual ringing system in force on the Chicago Board of Trade, let us study a typical ring settlement:

Assume that A sells to B 50,000 bushels of May wheat and purchases from C the same quantity (the price does not enter into the question). If B sells to C 50,000 bushels of May wheat, A can "ring" these contracts, and the result is a transfer to C of A's contract with B. B can also settle his contracts with A and C, and C can settle with B and A. In this manner offsets are effected which result in settlements by all the parties concerned.

To make the matter perfectly clear, let us set up the contracts on the various records of A, B, and C.

A's record shows a sale to B of 50,000 bushels of May wheat and a purchase of 50,000 bushels from C.

B's record shows a purchase from A of 50,000 bushels of May wheat and a sale to C of 50,000 bushels.

C's record shows a purchase from B of 50,000 bushels of May wheat and a sale to A of the same quantity.

Hence the following offsets or ring settlements are made in the three records:

A, in offsetting the account of B, enters 50,000 bushels on the left-hand side of the record and refers to C in cross-reference. C's account on A's books is offset by an entry on the record, with B's name as a cross-reference.

On B's record the names of C and A appear as offsets,

respectively, against the purchases and sales made with C and A. Thus, the same result is accomplished as on A's books.

On C's record the names of A and B establish a cross-reference, and thus set-offs are effected against the contracts.

The Ring Room

A word of explanation may be given here as to how the ringing method is carried out in practice. The Board of Trade has established a common meeting-place where the clerks of the various brokers assemble each day. Each clerk has in his possession a slate book containing the names of purchasing and selling brokers and the number and classification of options which each broker has open on the Street ledger, i.e., a list of unliquidated contracts.

A's clerk makes it his business to see B's clerk, or vice versa. An exchange of names then goes on until A or B calls the name of C. Immediately the possibility of ringing, or offsetting, let us say, 10,000 bushels of May wheat presents itself. The ring is called off by the party making it. Thus, if A makes a ring with B, the names in the ring run as follows: A sold to B, B sold to C, C sold to A. If B makes the ring, the names read thus: B to C, C to A, A to B. And if C makes the ring, they run as follows: C to A, A to B, B to C.

The same procedure is followed by all the clerks until as many rings have been made as possible. Rings made on one day are settled the next business day, together with any direct settlement which may have been made between the brokers.

Settling Contracts

The accountant, in reading the record kept by A, should keep these facts before him:

1. That it is only a memorandum book (conveniently called a ledger) in which are stated the contracts bought from or sold to other members.

2. That while the account may appear in the name of B, the purchase and sales of contracts therein listed should not be interpreted to mean that A bought or sold for the account of B, but rather that A bought from and sold to B the items listed, which either await settlement or which have been settled by specific performance, direct settlement, or ring settlement.

As a consequence of these interbroker transactions, payments are made for the amount of the differences between purchase and selling prices. When a contract is consummated by direct settlement, it might be inferred that a check is sent in liquidation of the amount due. But suppose that the trade is settled by means of the ring method—suppose A buys from B at $1.90 and sells to C at $1.95, while C sells to B at $1.98—what price should be adopted for the liquidation of these ring settlements?

Settlement Prices

According to Section 6, Rule 22, of the Board, "The current market value of the property contracted for shall be conspicuously posted at a stated hour each day, in the Settlement Room of the Association, which posting shall serve as a basis for the adjustment of all contracts settled."

Reverting to the previous transactions between A, B, and C, assume that the settling price is $1.90½. What payments take place?

A's Settlements. A's contracts cover a purchase of 10,000 bushels of May wheat at $1.90 from B, and a sale to C at $1.95. A's customer receives credit for $500. How does A receive this money as a result of the ring settlements made between A, B, and C? The rule is as follows:

First, apply the settlement price of $1.90½ against A's purchase from B. To record this an entry is made similar to that which would have been made had he sold to B. The

result is as follows: Bought at \$1.90, ring price \$1.90½, difference of ½ cent on 10,000 bushels, or \$50, which is the amount due to A from B.

Second, apply the settlement price of \$1.90½ against the contract sold to C at \$1.95, making an entry similar to that which would have been necessary had a purchase been made from C. Thus: subtract ring price of \$1.90½, from sold price of \$1.95, and the difference of 4½ cents on 10,000 bushels equals \$450. This amount is due A from C. The total received by A from B and C amounts to \$500, thereby equaling the profit made by A's customer. In this way A is reimbursed for the credit given by him to his customer.

B's Settlements. B has bought from C at \$1.98 and sold to A at \$1.90, thus losing 8 cents on 10,000 bushels, or \$800. Applying the settling price of \$1.90½ the result is: (1) the payment to C of a 7½ cents difference, or \$750, (2) the payment of \$50 to A, which makes a total of \$800.

The rule of applying the ring settlements against the purchase and sale contracts respectively, as is done in A's books, is to be applied here in order to obtain the above results.

C's Settlements. C has bought from A at \$1.95 and sold to B at \$1.98, realizing a profit of 3 cents a pound or \$300 on the 10,000 bushels of May wheat. Again adopting the settling price and applying it as before, the following results are obtained: (1) the payment of 4½ cents a pound or \$450 to A; (2) the receipt from B of 7½ cents a pound, or \$750; and (3) net result, a receipt of \$300, reconciling the profit realized with the amount received.

Clearing House of the Board of Trade

The question might properly be raised whether A, B, and C enter into a secret understanding whereby each party agrees to a subrogation of the others' claims. Such is not the case, because a common instrumentality is used, namely, a clearing

Chicago, Oct. 20, 1920 Report of "a" Number of Items cleared 2

TO THE CLEARING HOUSE OF THE BOARD OF TRADE OF THE CITY OF CHICAGO, OF ALL BALANCES OF OFFSETS AS PROVIDED BY RULE XXII, SEC. 6.

We claim from	1	We owe to	We claim from	2	We owe to	5	We owe to	Recapitulation	
								Column	Claims
	A					S		1st	500 -
								2nd	
				D				3rd	
								4th	
								5th	
50 -	B					T		Total	500 -
								Add Bal.	
				E				to Pay	ø
									500 -
450 -	C					U		Column	Owes
								1st	
				F					
								5th	
								Total	ø
								Add Bal. to Collect	500
500 -									500
CLAIM 1		OWE 1	CLAIM 2		OWE 2		OWE 5		

Form 24. Chicago Board of Trade Clearing Sheet

house through which these offset credit and debit items are cleared daily. This institution works along the lines of the ordinary bank clearing house, where debit and credit items are offset and only one settlement by each bank takes place instead of many settlements. In the case under consideration B, who is the sole debtor, pays $800 to the clearing house, which in turn honors A's draft on it for $500 and C's draft for $300. A, B, and C each file a clearing sheet daily, showing the amounts due to or claimed from other brokers.

A's sheet appears as shown in Form 24.

Records of Board of Trade Settlements

By reason of the system of clearance on the Board of Trade, the broker in Chicago, in addition to recording the transactions of his customers, is also compelled by rules and regulations to keep a record of his settlements with other brokers. His system of accounting is similar to that employed by members of New York commodity Exchanges in every respect except in the matter of clearances, which are unlike those on the New York Exchanges. As a result of this it is necessary for him to keep such additional books of account as will show his relationship to other member brokers in Chicago. Therefore he records transactions not only in the purchases and sales book, customers margin book, customers contract book, analysis journal, customers ledger, general journal, cash book, and general ledger, but he also keeps books to record his transactions with other brokers. A brief explanation of these books follows.

Contract Blotter

The daily transactions are written up in the contract blotter and sorted according to the commodity. Opposite the entry appears the name of the broker with whom the trade was made. This facilitates the posting of the transactions to the second

May DELIVERY BROKER Logan + Barnett

BOUGHT FROM			SOLD TO				
DATE	PRICE	REMARKS	DATE	PRICE	REMARKS	DEBIT	CREDIT

Form 25. Street Ledger

book, the Street ledger. In this book (Form 25), which has been referred to briefly as a "record," several pages are allotted to each broker showing the respective commodities contracted for and the specific contracts or delivery months. The accounts with broker B, for example, will show contracts in May wheat, May corn, May lard, December pork, September ribs, etc.

Arrangement of the Street Ledger

Being posted from a contract blotter, the Street ledger contains all the facts relating to the original transaction and the eventual consummation of this transaction by offset through direct settlement, ring settlement, or delivery settlement.

The title of the page indicates clearly the name of the broker with whom the contract has been made and the specific delivery month of the given commodity. The columnar arrangement is as follows: to the extreme left, the date of purchase or settlement (as each contract in wheat, for example, is 10,000 bushels, one line represents one contract); the second column provides for the price; the third, for remarks, i.e., for cross-reference to the broker with whom a ring settlement has been effected. Following this is a dividing line separating the purchases from the sales side. An entry on the left side of the page may indicate either a purchase or a ring settlement against a previous sale, and vice versa; an entry on the right side may indicate a sale against a previous purchase, or it may indicate a ring settlement. This second division, or right-hand side of the ledger, also contains columns for the date, price, and remarks.

As settlements are inevitable, suitable provision is made for a record of the receipts and payments of money. The ledger therefore provides for two monetary columns to the extreme right of the page; one for the payments to others as the result

of adverse settlements, and the other for receipts from others as the outcome of favorable settlements. When payments and receipts are spoken of, those effected through the medium of the clearing house are referred to exclusively.

The ledger not being a book of account, no significance is to be attached to these monetary columns, which merely indicate the settled status of recorded contracts. Since the net payments or receipts effected through the clearing house are credited and charged respectively to Contract Differences, that account only is of financial significance for trial balance or balance sheet purposes.

Brokers' Margin Record

The title of this book is indicative of its contents. It records margins deposited with the clearing house as security against any possible loss which might be sustained through the failure of the member with whom contracts were made and which are still unliquidated. For example, if broker A sells to broker B 50,000 bushels of May wheat at $1.95, and the price subsequently declines to $1.80, the difference of 15 cents per bushel on the unliquidated contracts may be demanded by A from B, the latter responding by depositing in trust a check or securities equaling in value the market impairment on B's contracts. Hence, a record of all open contracts is kept in this margin book and a daily inspection determines the marginal status of all contracts with B on A's books. If the market price operates against B, a margin call is issued by A to B, who makes a deposit as explained above. It is incumbent upon the one whom the market favors to issue the call to the broker whose contracts show impairment from the original purchase or sales price. When the contracts are liquidated by direct, ring, or delivery settlements, and the difference is paid to the claiming party, the margins previously deposited are restored to the broker who originally deposited them.

Settlement Book

This record shows all the items claimed from or due to other members on liquidated contracts. One page is allotted to "owed" items and the other to "claimed" items. In fact, the record is kept as a means of perpetuating the items settled each day through the medium of the clearing house.

Contract Differences and the Point Balance

The Contract Differences account for Chicago commodities can be proved by the same method as described in the section of the book dealing with cotton brokerage.

Closing the Books

The final accounting in conjunction with closing the books containing transactions in oil, coffee, sugar, grain, and provisions, necessitates adjusting entries similar in every respect to those described in the discussion of cotton brokerage.

Filing Form 747

The Internal Revenue Department has ruled that Form 747 must be filed for each commodity dealt in for future delivery on the Exchanges. In Appendix F are given the department's general instructions for making out the form.

The material points in the return are the manner in which transactions are settled and the amount of tax paid on the gross sales during the month.

The statement begins with the contracts carried over from the last preceding month, and then recites the options purchased and sold and the tax paid upon the total daily sales of the respective options. To simplify the tax payments, the Internal Revenue Department permits the broker to make a monthly payment in stamps to the clearing houses of the various commodity Exchanges, covering the entire assessment at the rate of 2 cents per $100 of value and fractions thereof.

PART IV

BROKERAGE AUDITING

CHAPTER XXVI

AUDIT OF STOCK BROKERAGE BOOKS

Purposes of Audit

The auditing of stock-brokers' books is a new departure for the accountant. Because of the technical brokerage knowledge required, an auditor can accomplish very little without a thorough knowledge of Wall Street technique. Nevertheless, it should be recognized that there is as much need for an audit of the Street's records as there is for the examination of records in any line of commercial endeavor.

At this point the following extract from the report of Governor Hughes's Commission on Speculation in Securities and Commodities (1909) is of interest as indicating the Commission's position on periodic audits:

> Failures and examination of books: The advisability of requiring by State authority an examination of the books of all members of the Exchange, analogous to that required of banks, is urged upon us. Doubtless some failures would be prevented by such a system rigidly in force, although bank failures do occur in spite of the scrutiny of examiners. Yet the relations between brokers and their customers are of so confidential a nature that we do not recommend an examination of their books by any public authority. The books and accounts of members of the Exchange should, however, be subjected to a periodical examination and inspection pursuant to rules and regulations to be prescribed by the Exchange, and the result should be promptly reported to the Governors thereof.

Granting, then, the necessity for periodic examinations of brokers' books, what should an audit of brokerage records show? Ordinarily it should result in a report by the accountant, commenting upon the financial condition of the

client, passing upon the correctness of the financial statements, and construing such of the financial reports as focus the operations of the period under review. Robert H. Montgomery gives the general purposes of an audit as follows:[1]

> To ascertain the actual financial condition and earnings of an enterprise for:
>
> (a) Its proprietors (partners or stockholders)
> (b) Its executives (managers, officers, or directors)
> (c) Bankers or investors . . . .
> (d) Bankers who are considering the discounting or purchasing of its promissory notes.
>
> and to detect:
>
> (a) Errors of principle
> (b) Clerical errors
> (c) Errors of omission
> (d) Errors of commission
> (e) Offsetting errors.

With the purposes of an audit thus defined, let us consider the usefulness of such an examination to the broker. First, an audit will serve his interest by giving him a comprehensive and intelligent statement of his business, its earnings and financial status. Second, it will help him in the future management of his business. Third, an audit will help him materially in procuring the necessary surety insurance.

It may also be said that there is a satisfaction in the knowledge which an audit gives that no irregularities are occurring. In the brokerage business the possibilities of speculation are great. "Money" is the only commodity handled, and there should therefore be no doubt as to the expediency of periodic inspections by a competent person and as to the value of a statement from him certifying to the condition of the business and the correctness of its operation.

Before proceeding further the point should be emphasized

[1] Robert H. Montgomery, Auditing Theory and Practice, 1912, pp. 11, 15.

that an audit, whether made at the instance of an Exchange, a partner, or a customer, should not be superficial; it should be intensely scrutinizing. More than once have accounts been passed over whose very construction should have elicited profound questioning by the auditor. The accounts spread upon the broker's books are too crowded with values to allow of a perfunctory handling.

Scope of Audit

The scope of a Wall Street audit is the next important matter. What does it call for? Is it to be a periodic audit? Is it to be a thorough examination or an inspection of one particular account? What should the audit of the securities department embrace?

The following is an outline of the requirements of an audit which calls for a thorough examination of a concern with memberships on all the important Exchanges:

1. Verification of cash—petty and general.
2. Proof of the correctness of stock accounts receivable, long of securities.
3. Verification of accounts receivable having no equity in securities but representing for the most part credit advances to customers for the purpose of investment and speculation—open debits which are considered perfectly collectible.
4. Examination of notes receivable lodged with the broker.
5. Ascertainment of the sufficiency of margins on all commitments in the market.
6. Physical examination of securities in the broker's possession representing the purchases of customers on a marginal basis.
7. Physical examination of securities which the broker is holding for safe-keeping for his customers.

8. Confirmation with brokers in the Street of any loans made on collateral by the client, paying special attention to the nature and adequacy of the collateral in the loan, the interest rates, and the duration of the loan—whether on time or demand—and if on time, whether for 30 or 60 days, or for a longer period.
9. Examination of securities owned by the broker and the place of deposit.
10. Depreciation of such securities.
11. Examination of the item "furniture and fixtures," particularly as to the matter of depreciation and whether any capital assets of this class have been charged to income. This error when committed is usually due to lax conduct of affairs and total ignorance of proper accounting principles.
12. As many brokers also do a banking business, they frequently have their own buildings, upon which taxes are payable and upon which depreciation is to be calculated.
13. The item of stocks borrowed against short sales is important enough to warrant confirmation by the lender of the description and number of shares, and of the price and rate at which they have been borrowed.
14. Dividends which have been or are to be received on long stocks should receive careful attention.
15. Treatment of dividends in the event of an even interest in the stock, that is, where some accounts are long and others are short of the same security during dividend time.
16. In connection with dividends, the consideration of due bills receivable to corroborate the right to dividends, the payments of which are pending.

The foregoing list of audit requirements relates to the asset section of the balance sheet. On the liability side, the audit should embrace:

1. Accounts payable representing:
   (a) Open credit balances, in which, however, the accounts have no further equity by reason of long securities.
   (b) Open balances, when the accounts also include holdings of stocks or bonds.
2. Verification of accounts payable subject to the purchase, or cover, of short securities.
3. Certification of the correctness of the Notes Payable account.
4. Verification of dividends payable, whether arising from borrowed stock or from certificates having remained in the client's name after the date of sale. In connection with this the due bills outstanding which attest to liability for dividend payments by the client should be proved.
5. Examination of Stocks Loaned account, covering names of borrowers, number of shares, description of issues, and the prices and rates at which the loans stand.
6. Confirmation with the lending bank or broker of any money borrowed on collateral by the client, corrobating the amount of the loan, its duration, the collateral, and the rates of interest.

The third list of audit requirements concerns itself mainly with the economic or income statement accounts. For this it is necessary:

1. To examine into the adequacy of reserves provided for depreciation of fixed assets and doubtful accounts, directing such adjusting entries to be made

as seem necessary or consistent with the policy of the client whose books are being examined.

2. To verify the Commission account, which will present no little hardship, for here it will become necessary to check the individual credits and debits from the blotters—clearing house and ex-clearing house—or from the purchases and sales books.
3. To verify the interest on customers' accounts.
4. To verify the interest debits or credits on account of stocks loaned or borrowed.
5. To verify the premiums on stocks loaned or borrowed.
6. To confirm with the lender or borrower the interest on money borrowed or loaned.
7. To examine into the apportionment over the period of membership dues usually paid in advance.
8. To examine into other deferred debit items, such as insurance on building, taxes, etc.

Finally, the capital accounts of the partners and the just distribution of profits and losses according to the articles of copartnership will claim the attention of the auditor in charge of the examination.

CHAPTER XXVII

AUDIT OF STOCK BROKERAGE BOOKS
ASSET ACCOUNTS

While the audit outline of the preceding chapter is fairly comprehensive, it might include a number of other factors which are likely to be encountered in any particular audit and which must be given careful consideration. For instance, there may be a substitution of securities while the securities accounts are being inspected, or a sale of certain securities while the auditor is working on the account in which they are entered. Such possibilities must be recognized and provided for, as it is obvious that if once the control of securities is lost continuance of the examination becomes absurd.

In the present consideration it is not intended to lay down any hard and fast rules of procedure, but only to suggest the method of verifying unusual items and to call attention to those features of the audit which require more careful attention or involve a special procedure.

Stock Accounts Receivable

Unlike the mercantile business where almost every entry grows out of the purchase, sale, or return of merchandise, and where a charge to a customer's account presupposes such a transaction, the accounts receivable of stock houses may represent several other kinds of transactions. They may show purchases of stocks still "long," balances without equity to the customer, or mere advances to the trader for one reason or another.

The only sources of entries to the customers ledgers are the blotters, the duplicates of the memoranda of purchases or

sales sent to customers, and the supplementary journal. These records may therefore be depended upon to reveal a complete history of the transactions appearing in the accounts receivable. Having by this means established the accuracy and the nature of the particular account under examination, we must admit such possibilities as may require further proof of the regularity and correctness of any particular account. Is it identified by a number instead of a name? Or does it bear a misleading letter? In either case the rule to be adopted is the authentication of the account by the client, or by some person in authority. There need be no cause for immediate alarm when a numbered or lettered account is met, for in no other business, perhaps, are the accounts of large customers more sacredly guarded. Nor is there anywhere greater need for a positive verification of accounts receivable than here. Much collusion can be practiced by clerks through the operation of fictitious accounts—a fact that some years since was brought out very forcibly by the testimony of a member of a certain Exchange, whose concern carried the account of a prominent executive of Albany. More recently the suspension of brokers has been brought about by the speculation of clerks using fictitious accounts.

In any event, the auditor should insist upon a statement from his client to the effect that all such numbered or lettered accounts are known to him. Also the identity of the customer should be made known to the auditor, whereupon the usual letter of the client should accompany the auditor's request for verification of balances and securities as appearing upon the statement of the customer. At the same time, the number of shares, the description of the securities, the balances against or in favor of the customer, should be recorded on a separate statement for the auditor's benefit; or else the statement of the customer should be duplicated or copied in a press book before being mailed to the customer. Invariably the customer will

respond very slowly, or not at all, and a second request should be sent by registered mail.

If still further scrutiny is desirable, the auditor may go to the length of procuring the client's authentication of all signatures subscribed to the returned letters of confirmation. If any of the customers fail to reply after repeated requests are made, the client should be apprized of the fact in the report rendered at the close of the examination.

Under stock accounts receivable another salient feature should be noted, namely, the sufficiency or insufficiency of margins. As has been pointed out under the subject of equity tables, a customer's account may be approaching the danger mark as far as his margins are concerned. Again, there may not be a vestige of margin left in the account, so that the difference between the ledger debit and the market value of the securities held by the customer results in a deficit to the customer's account after sale. Here the nature of the account would change from a stock account receivable to an ordinary doubtful or uncollectible account receivable.

Guaranteed Accounts

In his investigation the accountant should not only be careful of numbered and lettered accounts, but he should exercise due diligence in the matter of guaranteed accounts. Very often it is not apparent from the ledgers that a deficit account, in which the debit balance is not fully secured by the market value of the collateral therein contained, may be guaranteed by the account of another customer with a credit balance sufficiently large to secure the guarantor's debit balance and also that of the person whose debit balance is guaranteed. This information may not be disclosed to the auditor unless a written guarantee is on file in the broker's office.

In conclusion, it may be said that a general classification should be made of the various stock accounts receivable,

grouping together margined accounts, deficit accounts containing securities and those not containing securities.

The Revenue Stamps Accounts

The Revenue Stamps accounts are nothing more than inventory accounts. They record the purchase of stamps on the debit side and the consumption figure on the credit side, which represents the use of the stamps on account of sales or transfers. The balance figures should agree with those resulting from a physical inventory taken by the auditor.

The item of revenue stamps is an important one requiring keen inspection, as the amount carried by a large brokerage house may be very considerable.

Securities of Customers—Stocks

Whether the customer is long or short of securities, every single share of stock as recorded by the securities ledger should be traced to its place of deposit. If a customer, for instance, is long of 100 shares of Steel, the stock should be in the vault, in the transfer office, in a stock loan, in a collateral loan with some bank or broker, or should appear as a Failure to Receive item. Its location should be confirmed by physical examination.

Or, if a customer is short of Steel, the shares should be accounted for in one of two ways: if they are borrowed, by communicating with the lender; or, if 100 shares of long Steel held by another customer have been used to make delivery against the short, by checking against the securities record. It should be remembered that the broker may use securities long and carried on margin only upon certain conditions.

Under Section 956 of the Penal Code, securities deposited for safe-keeping only must not be used by the broker without the customer's permission. As a general rule all securities deposited for safe-keeping only, or which have been paid for

by customers, should be placed in individual envelopes and kept in a special deposit box or vault.

Wherever possible, in cases involving such securities, a thorough examination of the certificates of stock should be made. If the auditor is engaged in verifying securities and occasion should arise for the broker to use a particular certificate of stock, the serial number should be taken and a notation made accounting for this certificate in one of the following ways:

1. Sale.
2. Pledged as collateral in a loan.
3. Lent out in the Street.
4. At the transfer office for re-registration.
5. At the bank for purposes of substitution; that is, to be exchanged for such securities as might be necessary for delivery against a sale.

In the last case, the certificates which are received in return should be accounted for by a record being made of their receipt.

Bonds

Bonds are either registered or coupon in character. In examining coupon bonds it should be noted that all coupons are intact, and any irregularities should be brought to the client's attention. For example, if a bond bearing January and July coupons be examined in June, it should bear the coupon of July of the same year and all others until maturity. Defaulted bonds should carry all coupons since the date of default.

The necessity of determining whether all coupons have been placed to the credit of the account owning the bonds becomes very patent. Coupons, while they are negotiable (being bearer instruments), are nevertheless subject to a col-

lection rule laid down by most banks, namely, that all coupons must be enclosed in an envelope bearing the name of the depositor and that of the corporation by which the coupons are payable. Some check on the coupons is possible along these lines.

If registered as to interest, registered bondholders receive interest checks direct from the paying company. Here too, a watchful eye must be given to the payments of interest made during the period, or pending between the commencement of the examination and the completion thereof. In the matter of bonds registered as to principal, the serial numbers should be recorded, and it should be noted that the bond is not negotiable in nature.

Depreciation of Securities Owned

Securities may be held for investment by the broker. In such cases the tendency is to carry securities at cost, but conservatism and good accounting principles dictate the practice of taking cognizance of any change in values, particularly if such values show a depreciation. As the auditor is employed to examine books and not to criticize methods or policies of his client, he can hardly do more than make the matter of depreciated values an item in his report. Needless to say, if he is requested to adjust values he should not overlook this important account.

Money Loaned Account

It is not an uncommon practice for brokers to lend money in the "money loan crowd" of the Exchange. A loan thus created is subject to examination by the auditor and should be confirmed by the borrower as to the collateral behind it, its amount, its rate of interest, and its duration. Inasmuch as the loan envelope is available for inspection, this should be taken advantage of to substantiate the record of it appearing

in the Money Loaned account in the general ledger. The adequacy of margin should be investigated, and in the event of insufficiency should be brought to the notice of the client. With respect to liquidated loans, the auditor should test the correctness of the interest received on them.

Internal Check of Securities

In large brokerage houses it becomes a very serious problem each month to establish the accuracy of the entries in the securities record. Where the volume of business is heavy, it is most expedient to resort to a monthly verification of the record.

The following procedure is suggested to the accounting department or the visiting accountant as one which is most convenient and thorough in determining beyond a doubt the location and status of all stocks and bonds, either in the custody of the broker or pledged by him:

1. "Take-off" sheets are compiled from the margin records as of the day preceding the last business day in the month. This date is taken because the transactions occurring on the last day of the month are passed on the books the first of the following month, and are thus beyond the scope of the work in hand. Starting with A. Adams and proceeding to Z. Zayers, the respective holdings of customers, as evidenced by the margin records, are transferred to these take-off sheets. These sheets are arranged alphabetically in order to facilitate the sorting of securities.

2. The take-off sheets above referred to are now analyzed and are then grouped under the captions descriptive of the security which is to be classified. As an example, taking A. Adams' account, the Anaconda shares are listed on the classifying sheet under the Anaconda heading. The same stock appearing in B. Brown's account is also transferred to the classifying sheet under the Anaconda listing. The same pro-

cess is repeated for each stock or bond until all the customers' or the firm's holdings are registered on the classifying sheet.

3. The confirmations sent to banks in connection with the verification of collateral bank loans and those sent to brokers to check stocks borrowed and stocks loaned as of the last day of the month are all manifolded, so that duplicate copies of each are retained in the office and made to serve in assisting the verification of the securities record. These duplicates are arranged alphabetically, also according to bank loans and stocks borrowed or loaned.

4. As the securities in transfer, securities in vault, and "failed to receive" or "failed to deliver" books provide such information as is required for a complete verification of securities, listings are compiled from these respective books, or the books themselves are used as a basis for checking against the stock record.

We are now ready to proceed with the checking of the securities record. As this book is arranged alphabetically, according to the name of the stock or bond, the record is called first on the "long" side and then on the "short" side. As an example, if A. Adams is long of 100 shares of Anaconda, the Anaconda sheet in the securities record reveals this fact, and the classifying sheet, under the caption of "Anaconda," substantiates the fact that Adams is long of 100 shares of the above-named security. The disbursement, or the credit side of the Anaconda sheet in the securities record shows the disposition of these shares, and if they appear in the Chase National Bank as collateral, the duplicate confirmation covering the loan with the Chase National Bank bears testimony to the position of the shares referred to. The same procedure is followed in the case of stocks borrowed, stocks loaned, securities in the vault, securities in transfer, and stocks "failed to receive" or "failed to deliver." In this way the verification is complete in all respects; any errors discovered are immedi-

ately adjusted, and the stock record becomes a perfect basis for the ensuing month's audit.

The foregoing suggestion outlining the procedure in relation to the internal check of securities emphasizes the necessity for analyizing the securities record into its component parts, in order to make possible a complete verification of the stocks and bonds of which customers may be either long or short.

At times difficulty is experienced by the auditor in gaining access to the securities record, as the book may be in use at the time it is wanted. Under such circumstances it is advisable to compile the position of the securities from the underlying records, which are as follows: depot or vault list, active box book, transfer register, stocks loaned book, money borrowed book, stocks borrowed book, "failed to deliver" book, "failed to receive" book. The completed compilation is nothing short of a duplicate securities record and is made part of the report submitted to the client. It also provides an excellent means of determining the accuracy of the record itself for the period under review. This is done by checking the compilation proper as soon as the book is released to the accountant. The second method just outlined provides a more efficacious check upon the securities record, since the book may be tampered with in the absence of the accountant.

Call Loans

There is much to be said about call loans inasmuch as the interest rate is variable, and it behooves the auditor to check not only the prevailing rate of interest but also the changes from the day the loan is made up to the time of making the audit. Since the lender is only pledgee for the securities, he may hold them only as a pledge and not use them for any purpose. If he does use them, each instance of such use may render him liable to a charge of conversion. For this reason, the whereabouts and use of such securities should be carefully

investigated and attention should be immediately called to any irregularities discovered.

On time loans the same general procedure is to be followed, the only difference being in the interest payments. This is touched upon in Chapter XXVIII.

Furniture and Fixtures

It is almost a fixed rule among brokers to charge the cost of furniture and fixtures to income. In principle this practice is very wrong. In such cases it devolves upon the auditor to explain that an account should be set up with furniture and fixtures showing the purchase price, which usually amounts to many thousands of dollars. When this account is found, the auditor upon questioning will usually be told that a nominal rate of 10% is annually charged off on account of depreciation. If no reserve for such depreciation has been set aside, the practice should be advocated. Usually it will be found that the broker is either too conservative in his accounting allowances or too liberal. The tendency, very regrettably, leans strongly towards carelessness.

Land and Buildings

A few of the larger brokerage concerns occupy entire buildings for their business use. They may own or lease these buildings. Where the building is owned, the necessity for a depreciation account should again be emphasized. Also the items of taxes and insurance should be intelligently accounted for, apportioning the insurance over the period and making due allowance for the accruing taxes.

Stocks Borrowed

The subject of stocks borrowed has been discussed in connection with customers' short sales, but for auditing purposes it should be treated under a separate heading.

Stocks borrowed are equivalent to money loaned appearing among the assets. However, the constant marking up and marking down of values while the stock is borrowed presents no little task to the auditor, who must consider the various changes that have taken place since the particular stock was borrowed. All such changes in value and interest rates should be listed and the listing made the contents of a letter of confirmation sent to the lending broker.

Dividends Receivable

Among other items of importance to the auditor is that of dividends. The schedule of dividends receivable should show the shares of stock upon which dividends have been or are to be received. In proving the correctness of the schedule, the securities record should be consulted for information in regard to the long stocks upon which dividends are due. A record should be compiled of the purchases and sales of all dividend-bearing stocks within the period, closely watching for sales and purchases before dividend declaration time. By checking the open longs with the official Exchange dividend lists, or any other dividend indicator, the status of the Dividends account can be proved.

Credits may appear in this account, in order to record due bills for dividends received by other brokers on stocks sold after the dividends were declared but before they were paid. When such due bills are held they should be carefully examined and confirmed by the brokers that issued them.

Finally, in proving the Dividends account it should be kept in mind that when long stock is offset by a short sale of the same stock, no dividend is received on it, and hence no entry is made in the Dividends account. However, as shown in the supplementary journal, the "long" customer is credited and the "short" customer is debited for an amount equal to the dividend. It is obvious that this situation precludes the

possibility of a dividend being received from the company if the certificate was transferred by the buying broker at the time delivery was made by the client broker against a sale for his customer. The point is mentioned here merely to put the accountant on guard should he meet such a situation. Of course, it must be borne in mind that the client may receive dividends on stock in which he has no net interest, due to the fact that the buyer could not or did not transfer the certificates in time to receive the dividend check direct from the corporation. In such a case the client owes the dividend to the buying broker.

Having compiled such information as can be used to check the entries in the Dividends account, the auditor should proceed with the checking of dividend credits appearing in the customers' accounts. In this connection it should be remembered that it is the practice of some concerns to credit the customer's account upon declaration day rather than on the payment day. This practice is incorrect. If the important facts be kept in mind, little difficulty should be experienced in auditing dividends.

CHAPTER XXVIII

AUDIT OF STOCK BROKERAGE BOOKS LIABILITY ACCOUNTS; INCOME ITEMS

Liability Accounts

Accounts Payable

The only accounts payable usually found in the audit of a broker's books are in the nature of short accounts and open credit balances with or without long securities. The securities in accounts with credit balances should always appear in depot, i.e., should be held by the broker for safe-keeping only.

The procedure here is to check the transactions of the period covered against the blotters, duplicate sales notices, the supplementary journal, and securities ledger. The interest allowed on open credit accounts should be proved. The appearance of interest at a rate higher than the call money rate should provoke inquiry, as a Stock Exchange rule enjoins such practices.

In determining the adequacy of margins on short accounts, the same procedure should be followed as in the case of long accounts receivable.

Approaching the subject of short accounts from the angle of stocks borrowed, it is important to determine whether the short stock is borrowed in the Street or from a customer. Under the present law to borrow stocks from "long" customers in order to make delivery against short sales is held to be conversion unless the "long" customer has signed a waiver giving the broker the right of hypothecation for the amount in excess of the balance owed by the customer.

The tendency on the part of the accountant is usually towards a complete verification of accounts receivable. It seems that no stone is left unturned in the accountant's efforts to prove the accuracy and to obtain verification of customers' debit accounts. However, there is just as much likelihood for an understatement of accounts payable as there is for the overstatement of receivable items. For this reason the liability items should be scrutinized as keenly as the asset items.

Customers with credit balances arising from short sales or those with "straight" credit balances should be sent requests calling for the verification of balances due them, both money and securities.

Dividends Payable

It has already been pointed out that the Dividends Payable account is created as follows:

1. Where stock sold before dividend declaration day remains in the client's name until after a dividend has been declared. In such cases, upon receipt of the dividend check, the Dividends Payable account is credited until the dividend is claimed by the broker holding the certificate of stock.

2. Where a dividend is declared on stock which has been borrowed from the Street. In this case the customer's account is charged when the dividend is paid by the company and a check is sent to the lending broker.

The further procedure in verification of dividends payable is similar to that prescribed for dividends receivable in the preceding chapter.

Stocks Loaned

The procedure in auditing the Stocks Loaned account is identical with that prescribed for the verification of Stocks Borrowed.

Bank Loans and Brokers' Loans

In the audit of loans from banks and brokers it is necessary to get the lender's confirmation of the collateral contained in the loan; also of the amount, the rate of interest, and the sufficiency of collateral. If it be a demand loan, the daily interest changes should also be noted in the letter of confirmation. In the case of a time loan, the duration should be stated, together with the interest accrued thus far. The agreement with the lender may call for the interest to be paid in advance, monthly, or at the liquidation of the loan. All such data should be confirmed wherever possible.

Income Items

Commissions

As was pointed out in a previous chapter, the commissions of the securities department may arise from two sources:

1. The execution of orders for customers.
2. The execution of orders for other members of the same Exchange, either for carrying transactions, clearances, or transactions in which the name of the principal is disclosed.

The charges against the Commission account result from:

1. Floor brokerage due to brokers for the execution of orders.
2. Commission owing to other brokerage concerns which may be carrying the client's commitments for him.
3. Commission charged on clearances.

All charges and credits to the Commission account should be proved by reference to the blotter or duplicate purchases and sales notices containing such entries, and by the compilation from the purchases and sales book of a statement of

orders executed by other floor brokers. The credits to this account arising out of the execution of orders for other concerns can be traced to the record from which the monthly commission bills are made out. This last record should be carefully scrutinized.

If any of these commission bills have not been paid, as evidenced by the books, written confirmation should be secured from the respective brokers for the purpose of verifying those outstanding items of which no previous cognizance had been taken.

Interest Charges and Credits on Customers' Accounts

Some customers ledgers are so ruled as to give the number of days for which interest is to be charged or credited, and the individual interest amounts are carried into an interest column. The net difference between the charges and credits is then passed through the ex-blotter or supplementary journal and debited or credited to the customers' accounts in the usual manner.

This arrangement is ideal but is seldom found in practice. The general rule is to make interest calculations on the statement, of which a press or carbon copy is made. The net amount of interest to be charged or allowed is entered net to the customer. Wherever this system prevails, use should be made of the press copy books or carbon copies to prove the interest debits and credits.

The auditor may also meet cases where no copies are kept, in which event it is safe to prove the interest on each transaction appearing in the accounts. Under the rule of the Exchange it is a violation of the commission law to rebate interest. Wherever such rebates are discovered they should be called to the attention of the client, so that proper adjustment may be made, if possible, or a recurrence of such violations prevented.

Interest on Stock Loans and Premiums

Exacting methods should be adopted in proving the interest and premiums on stocks borrowed and loaned. The stocks borrowed and loaned book offers the best foundation upon which to build the interest accounts. On clearing house stock returned or called recourse should be had to the clearing house blotter containing the record of the transaction. The interest should be thoroughly tested.

The premiums appearing in the premium accounts should be examined in like manner. The rule of the Exchange should be remembered, that premiums are not to be charged for Saturdays, Sundays, and holidays.

Where interest or premiums have accrued or are accruing, a confirmation should be sent to the other brokers. This procedure will disclose any errors or irregularities.

Expense Items

Expenditures are to be verified in the usual manner. It is well to get a statement from the client as to what expenditures are incidental or customary to the business. All vouchers should be examined carefully, and especially those concerned with the expenses of branch offices and solicitors.

Final Procedure

The auditor should examine the table of equities, being especially careful with accounts containing deficits and those with slim margins.

The system obtaining in the concern under audit should not be attacked unnecessarily, for the very good reason that unsolicited information is highly undesirable and may lead to unpleasantness. Of course it behooves the auditor to point out where losses and leakages can be prevented, but beyond that it is indiscreet to submit a dissertation on the weakness of the system or the morale of the office staff.

As a final word on the audit, the accountant should bear in mind that the report is more comprehensible to the client if Wall Street technical terms are used. It is a fact that the broker thinks and speaks in the parlance of the Street, and any other accounting terminology is as foreign to him as is his vernacular to the average layman.

CHAPTER XXIX

AUDIT OF COTTON BROKERAGE BOOKS

Outline of Audit

The audit of cotton brokerage books will require the verification or confirmation of the following:

1. Petty and general cash.
2. Accounts receivable representing open debit balances of credit customers and of marginal accounts, both having no interest in the market.
3. Accounts receivable with open commitments showing gains large enough to offset their ledger debit balances.
4. Accounts receivable, mainly credit accounts, whose open transactions show market losses, thereby augmenting the ledger debits.
5. Accounts receivable against which spot cotton warehouse certificates are held, creating equities in favor of the customer.
6. Notes receivable.
7. Clearing house margins deposited by the client.
8. Contracts open for account of customers, stating the date of purchase or sale, the option, and the price.
9. Contract Differences account, debit or credit, involving:
   - (a) Sending confirmations of open trades to customers.
   - (b) Checking account sales during the period embraced by the audit.
   - (c) Checking receipts from and payments to the clearing house.

(d) Proving the point balance, the result being the present balance of Contract Differences.

10. Accounts payable with customers, the verification being made in the usual way with careful notice of any numbered or lettered accounts.
11. Adequacy of margins on open commitments of credit customers.
12. Sufficiency of margins on the open trades of margin customers.
13. Spot transactions carried on margin—the charges for labor, storage, insurance, and interest always being added to the open debits.
14. Notes discounted.
15. Loans payable, containing collateral in the nature of warehouse certificates.

The following is also suggested:

16. Test thoroughly the Commission account, carefully verifying commission bills, receivable and payable.
17. Test beyond a doubt the correctness of interest on margins released, notes receivable, notes payable, and loans payable.
18. Give the expense factors the same careful scrutiny that was suggested for the securities audit.
19. Finally, determine whether the division of profits and losses accords with the articles of agreement.

Accounts Receivable

Unless the account is that of a credit customer, there should exist no customers' accounts receivable on the books of the cotton department, except in the case of a customer having open trades showing a profit not only equal to or exceeding his indebtedness but large enough to margin the account properly. It is almost a certainty that if any other accounts re-

ceivable are discovered, they should be written off entirely or a reserve set up against them. The auditor's report should call the client's attention to any deviation from this rule.

There is still another set of accounts, usually to be found among credit accounts, where a market loss increases the debit balance in the ledger. A credit of, say, $5,000 is extended to Harby and Company, who are long of 800 bales of May cotton on which there is a market loss of $3,500. Harby and Company's ledger debit is $300, making the total debit on open and closed commitments $3,800. The credit agreement with the customer should be known to the auditor, so that proper classification may be made of the customer's account on the balance sheet.

Other accounts receivable are fully secured by having as collateral spot cotton warehouse certificates. In such accounts items of interest, labor, storage, and commission are to be looked for. Storage and interest are charged monthly, while labor and insurance are charged upon expiration of the policy, or, as in the case of labor, when the cotton is moved at the time of sale or shipment.

Credit Accounts

While the Stock Exchange forbids the extension of credits to customers, the Cotton Exchange permits this practice where the person so favored is actively engaged in the cotton business. The extension of credits necessitates the utmost precaution, since it may lead to collusion between those in charge of the accounts and the customer. If a credit has been extended to a customer, he will not be required to furnish margin until he owes the broker the amount of credit extended. The margin clerk or the solicitor might enter into engagements for the account of the customer of which the latter might have no knowledge whatever. Only when the transaction was closed, or when confirmation of open trades or balances was

requested, would the fraud be uncovered. To guard against this abuse, all transactions for credit accounts should not only be doubly checked but regularly confirmed with the customer. Another safeguard is to examine very carefully the indorsements on checks sent to credit customers, in order to ascertain their genuineness.

Clearing House Margins

The clearing house margins deposited by the client must be verified, not only by examining the margin certificates, but also by sending written confirmations to the clearing house. On margins released within the period the accountant must prove the deposits and releases, paying careful attention that no excess margins are on deposit, for if there are such excess margins the broker loses the difference in interest between 6% and the rate the margin banks allow.

Open Trades of Customers

Statements containing a list of open trades should be sent to each customer for verification. They should be accompanied by explanation of their purpose and a request to the customer to return them at once.

Verification of the Contract Differences Account

The confirmed open trade statements received from customers should form the basis for verification of the Contract Differences account, in the manner prescribed under the section "Point Balance" (Chapter XXI). In this connection it will also be necessary to confirm with the clearing house all open trades, giving the number of bales, options, and prices.

The account sales rendered to customers should be checked for the purpose of testing proper charges and credits to the Contract Differences account. The receipts and payments

made on account of clearing house settlements should be checked against the cash book, which in turn should be proved by the monthly charges and credits in the Contract Differences account.

By setting up the facts as outlined the point balance will receive not only the usual check, but also the check involved in a thorough compilation of all the facts which may enter into the construction of the account that is under examination.

Accounts Payable

The accounts payable with customers represent margins deposited on market commitments. Under the law of the Exchange no interest may be allowed on deposits of customers' margins. If the rule has been violated, it should be brought to the attention of the client and the matter remedied immediately. A statement of each account payable mailed, with a request for confirmation, to the party to whom it is owing will assure a thorough check of this class of accounts. All the account sales should again be checked against the customers' accounts, including cash receipts from and cash disbursements to the customer, which should be checked with the cash book. Journal entries should also be checked, as they affect the accounts of customers through bank advices. The margins of customers should be looked into, calling attention to any weak accounts. The table of equities should always be consulted in regard to margins.

Commissions

Commissions should be checked from the contract analysis journal and from commission bills, receivable and payable. The suggestions as to the verification of unpaid bills in the stock brokerage audit (Chapter XXVIII) may well be adopted here.

Interest on Margins

Interest on brokers' margins should be tested in the following manner: (1) Ascertain the date of deposit and the date of release, and (2) compute the interest for the number of days that the margin has been on deposit.

Audit of Other Commodity Departments

The same procedure as outlined for the audit of the cotton department may be used in the audit of the produce, grain, cottonseed-oil, coffee, and sugar departments. The only difference arises in the matter of proving the contract differences. If the verification system by point balance is used as outlined in Chapter XXI, no difficulty need be experienced in determining the accuracy of the accounts.

Audits for Surety Bond Purposes

In the brokers' blanket bond policy issued by surety companies, a clause is invariably inserted relating to the duties of the insured so far as the audit of the books is concerned. The surety companies, as a rule, will insure a broker against defalcation arising out of collusion between the clerks in his office. The verification of accounts receivable is very important in this connection, as the surety companies cannot be held liable unless the auditors obtain complete confirmation of all accounts receivable. Failure to receive such confirmation after the first request should be no reason for desisting from the effort. Second and third requests should be made by the auditor over the client's signature and mailed to the customer by registered post. Surety companies will not as a rule insure one part of the accounts receivable to the exclusion of the remainder, unless the terms of the policy are strictly complied with. Generally the sending of second requests for confirmation by registered mail fulfils the essential condition of the policy.

The surety policy should be read carefully before beginning the audit, as in many cases the conditions of the agreement might necessitate a change in the general audit procedure covering the insured items on the balance sheet.

APPENDIX

APPENDIX A

GENERAL INSTRUCTIONS FOR STOCK TAX RETURN

To aid stock-brokers in preparing their monthly returns of transactions to the government, the Commissioner of Internal Revenue has issued the following general instructions:

1. *Persons Required to Make Return.* Every person who is wholly or partly engaged in the business of selling, transferring, or delivering shares of stock, whether at an exchange or not, or whether such sales, transfers, or deliveries are made, cleared, settled, or adjusted by himself or through a clearing house or otherwise, must make a return of all such transactions, legibly written in ink or prepared on a typewriter, to the Commissioner or duly designated officer. If during the month no transactions have been made by the person required to file the return, a statement to that effect must be filed in lieu of a return. Returns written with pencil will not be accepted.

2. *Date of Filing Return.* The return must be filed on or before the fifteenth day of each month for the transactions of the preceding month, or for any other period required by the Commissioner. A return mailed on the fifteenth day of the month will be accepted as if delivered on that date.

3. *Signature and Verification.* Returns must be signed and verified either by the person making such return or by his duly authorized agent, and must be sworn to before an officer authorized to administer oaths, and the seal of the attesting officer, if he is required to have a seal, must be impressed upon the return. The oath will be administered without cost by any collector or deputy collector of internal revenue or by any internal-revenue agent charged with the handling of such return.

4. *Returns to be Checked.* All figures on the return should be carefully checked against the facts as disclosed by the books of record.

5. *Statement of "Stock Transfer" Stamps Bought and Used and Consolidated Stamp Statement.* All "stock transfer" stamps purchased and used during the month, as well as stamps on hand brought for-

ward from the preceding month and the stamps remaining on hand at the close of business for the month reported, must be accounted for each month in the space provided for that purpose.

Special Instructions

6. *Separate Returns Required.* In the space provided for that purpose in the heading of the return must be written the name of the exchange or the exchanges where the transactions were made.

7. *Basis of Tax.* The bases of tax are three, namely: Shares having face (or par) value, tax at the rate of 2 cents on each $100 of face value or fraction thereof of the certificate; shares without face (or par) value of an actual (or market) value of $100 per share or less, tax at the rate of 2 cents on each share; shares without face (or par) value of an actual (or market) value in excess of $100 per share, tax at the rate of 2 cents on each $100 of actual value or fraction thereof of each share.

8. *Regulations and Penalties.* For further information regarding these matters, see Treasury Regulations No. 40, Revised, and consult the Internal Revenue Bureau in the district in which the person making the return resides.

APPENDIX B

NEW YORK STOCK EXCHANGE COMMISSION RATES

The commission rates which members of the New York Stock Exchange may charge are prescribed by the constitution in Article XXXIV, which reads as follows:

Sec. 1. Commissions shall be charged and paid, under all circumstances, upon all purchases or sales of securities dealt in upon the Exchange (except as provided in Subdivisions (h) and (i) of Section 2 of this Article); and shall be absolutely net and free from all or any rebatement, return discount or allowance in any shape or manner whatsoever, or by any method or arrangement direct or indirect; and no bonus or any percentage or portion of the commission shall be given, paid or allowed, directly or indirectly, or as a salary or portion of a salary, to any clerk or person for business sought or procured for any member of the Exchange.

Sec. 2. Commission shall be calculated on the basis of selling prices as hereinafter specified;

(a) On business for parties not members of the Exchange, including joint account transactions in which a non-member is interested; transactions for partners not members of the Exchange; and for firms of which the Exchange member or members are special partners only, the commission shall be not less than the following rates on stocks:

On stocks selling below \$10 per share	7½ cents per share
On stocks selling at \$10 per share and above, but under \$125 per share	15 " " "
On stocks selling at \$125 per share and over	20 " " "

provided, however, that the minimum commission on an individual transaction shall be not less than one dollar.

(b) On business for members of the Exchange when a principal is given up the commission on bonds shall be not less than on the following basis:

25 cents per $1,000 par value on bonds selling below 125%
30 cents per $1,000 par value on bonds selling at 125% and above

and not less than the following rates on stocks:

On stocks selling below $10 per share....................1¼ cents per share
On stocks selling at $10 per share and above, but under $125 per share..........2½ " " "
On stocks selling at $125 per share and over...........3 " " "

Except that when the amount dealt in is less than 100 shares, the commission shall be not less than:

On stocks selling below $10 per share........................1 cent per share
On stocks selling at $10 per share and over...................2 " " "

(c) On business for members of the Exchange when a principal is not given up the commission on bonds shall be not less than on the following basis:

37½ cents per $1,000 par value on bonds selling below 125%
50 cents per $1,000 par value on bonds selling at 125% and above

and not less than the following rates on stocks:

On stocks selling below $10 per share.....................1¾ cents per share
On stocks selling at $10 per share and above, but under $125 per share.............3¾ " " "
On stocks selling at $125 per share and over ....5 " " "

(d) In transactions where orders are received from a non-member, wherein the broker filling the order is directed to give up

another broker or clearing house, the responsibility of collecting the full commission, specified in Subdivision (a) hereof, shall rest with the broker or clearing house settling the transaction.

(e) In transactions where orders are received from a member, on which a clearing firm is given up by said member or by his order, the responsibility of collecting the full commission, as specified in Subdivision (c) hereof, shall rest with said clearing firm; and it shall be the duty of the broker who executes such orders to report such transactions to the clearing firm and render to them and collect his bill therefor at the rate specified in Subdivision (b) hereof; and also that where a broker executes an order for a member and clears the security himself, he must charge the rates specified in Subdivision (c) hereof.

(f) Whenever a non-member of this Exchange shall cause to be executed in any market outside of the United States any order or orders for the purchase or sale of securities listed on this Exchange (except as provided in Subdivisions (h) and (i) hereof), and said purchase or sale shall be accepted by a member or firm who are members of this Exchange, for the account of said non-member, the commission specified in Subdivision (a) hereof shall be charged said non-member in addition to any commission charged by the party or parties making the transaction.

(g) When securities are received or delivered on a privilege for a non-member, the commission specified in Subdivision (a) hereof must be charged whether said securities are received or delivered upon the day of expiration of said privilege or prior thereto.

(h) On Subscription Rights; Bonds or Notes of Foreign Countries having five years or less to run; Notes of Corporations having five years or less to run; Bonds having five years or less to run; such rates to members or non-members as may be mutually agreed upon; provided, however, that the Committee on Commissions with the approval of the Governing Committee may hereafter determine special rates on any or all of the above-mentioned securities.

(i) Securities of the United States, Porto Rico and the Philippine Islands, and of States and municipalities therein are exempted from the provisions of this Article.

APPENDIX C

THE STOCK CLEARING CORPORATION OF THE NEW YORK STOCK EXCHANGE

The following rules and regulations have been tentatively adopted by the New York Stock Exchange for its recently organized Stock Clearing Corporation:

The Stock Clearing Corporation is incorporated under the Laws of New York with a capital of $500,000, divided into 5,000 shares, all of which are owned by the New York Stock Exchange.

Purposes

As stated in the Articles of Incorporation, the purposes of the Stock Clearing Corporation are as follows:

> To provide members of the New York Stock Exchange and firms having as partners members of the New York Stock Exchange for whom it may act with facilities for clearing contracts between them and for delivering stocks and securities to and receiving stocks and securities from each other and for delivering stocks and securities to and receiving stocks and securities from banks, bankers, trust companies and others and for procuring the transfer of stocks and securities upon the books of the corporations or associations issuing the same;
>
> To act for each of the members of the New York Stock Exchange and firms having as partners members of the New York Stock Exchange who shall employ it upon terms and conditions satisfactory to it as agent in clearing contracts between the member or firm and other such members and firms and in delivering stocks and securities to and receiving stocks and securities from other such members and firms and in delivering stocks and securities to and receiving stocks and securities from banks, bankers, trust companies and others and in procuring the transfer of stocks and securities upon the books of corporations or associations issuing the same and in receiving from and paying to other such members and firms

amounts payable by or payable to such other members or firms in connection with the delivery of stocks and securities to or the receipt of stocks and securities from such other members or firms and in receiving the proceeds of loans and paying off loans made by banks, bankers, trust companies and others on stocks and securities;

To enter into all such contracts and do all things that may be necessary or proper to carry out the foregoing purposes and to protect the corporation against loss in carrying out the same.

Night Clearing Branch

The present Clearing House of the New York Stock Exchange will be the Night Clearing Branch of the Stock Clearing Corporation.

Day Clearing Branch

The operations of the Day Clearing Branch of the Corporation will be conducted in the building of the New York Stock Exchange.

The Day Clearing will involve two operations, viz.: the clearing of security balances and the clearing of loans, together with the clearing of special transactions approved by the Stock Clearing Corporation.

Clearing of Security Balances

Under the present system, a member of the Clearing House who buys 1,000 shares of United States Steel and sells 900 shares has a balance of 100 shares to receive and pay for the next day. If, however, he buys 1,000 shares of United States Steel and sells 900 shares of Southern Pacific, no economy is effected. Under the new plan, in the case suggested, the proceeds of the delivery of the 900 shares of Southern Pacific will go to reduce the debt caused by the purchase of 1,000 shares of United States Steel, so that it will only be necessary to provide for the payment of the difference.

Clearing of Loans

At present, when a loan is paid off which the broker wishes to reborrow, he must secure an intermediate credit from his bank for the purpose of paying off the old loan before the new loan is effected. Under the new plan, the banks or other lenders will send the collateral to loans to be paid off to the Stock Clearing Corporation and, while the securities are there, the old loans will be paid off and the new loans made and at the same time changes in collateral will be effected.

Clearing Members

Exchange members and firms for whom the Stock Clearing Corporation acts will be known as Clearing Members. Any Exchange member or firm who desires to use the facilities of either the Night Clearing Branch or the Day Clearing Branch of the Stock Clearing Corporation must become a Clearing Member. A member or firm desiring to become a Clearing Member must have his or its application approved by the Stock Clearing Corporation and must sign the form of agreement prescribed by it and must contribute the amount required by it to the fund known as the Clearing Fund.

Clearing Fund

The amount of the contribution from each Clearing Member to the Clearing Fund will be fixed by the Corporation which in determining such amount will have regard to the volume of the Clearing Member's transactions. The minimum contribution will be $10,000 and the entire fund will not be less than $10,000,000. Each Clearing Member will be subject to an additional liability equal in amount to his contribution to the Clearing Fund to make good losses affecting the Corporation. The amount of each Clearing Member's initial contribution to the Clearing Fund will be based upon the volume of his transactions in the present Clearing House if he has been a member of the Clearing House. Afterwards the amount of the contributions of Clearing Members will be readjusted from time to time according to the actual experience of the Stock Clearing Corporation which will, however, reserve the right to require an increase in the contribution of any Clearing Member at any time that the volume or nature of his business seems to make it advisable. The Clearing Fund will be deposited by the Stock Clearing Corporation in New York banks and trust companies.

Supervision of Clearing Members

The Board of Directors and Executive Committee will have the right at any time to examine into the transactions of any Clearing Member.

Termination of Clearing Membership

The Stock Clearing Corporation at any time in its discretion may cease to act for a Clearing Member and a Clearing Member may at any time require the Stock Clearing Corporation to cease acting for

him. When the Corporation ceases to act for a Clearing Member he will get back his contribution to the Clearing Fund after any share of the losses of the Stock Clearing Corporation for which such contribution is liable has been deducted and the Clearing Member has paid all amounts due by him to the Stock Clearing Corporation and all transactions out of which further obligations to the Stock Clearing Corporation might arise have been closed.

Anticipated Results

It is expected that the operations of the Stock Clearing Corporation will reduce the demand for day loans from the certifying banks by at least 65% and firms now maintaining bank balances for the purpose of securing such accommodation will be enabled to reduce their bank balances. Certification will not be entirely eliminated and reasonable bank balances will still have to be maintained but it is expected that the reduction in the bank balances which will be necessary for the Clearing Members to maintain will offset their contributions to the Clearing Fund.

Day Clearing Branch Operations

Night Clearing cash balances and security balances will be entered on a separate sheet with footings showing the totals of transactions. All such "balance" sheets will be delivered by the Night Clearing Branch to the Day Clearing Branch on the delivery day following their receipt. Security balance tickets will be given out at the Night Branch of the Stock Clearing Corporation at 9:00 A.M. on the delivery day and will have the names of members from whom and to whom the securities entered thereon are to be received or delivered.

Each Clearing Member must send to the Stock Clearing Corporation no later than 10:00 A.M. itemized lists of all security balances to be delivered and to be received as shown by the security balance tickets.

Bond balances must not be listed with stock balances but must be listed on separate lists provided for that purpose.

These itemized lists must be accompanied by orders signed by authorized representatives of the Clearing Members authorizing the Stock Clearing Corporation to credit the Clearing Members' accounts with the total value of the securities to be delivered and to charge their accounts with the total value of securities to be received, such credits and charges to be contingent upon the actual delivery of the

securities. Delivery of securities on Stock Clearing Corporation balance orders will be made direct between members as heretofore (unless otherwise directed by the Stock Clearing Corporation), but instead of payment being made as heretofore, the Clearing Member making a delivery will secure a receipt from the Clearing Member to whom the delivery is made which will be filed with the Stock Clearing Corporation and will confirm the charges and credits with respect to such securities.

Transfers of accounts and deliveries of securities other than deliveries on security balance orders may be made through the Stock Clearing Corporation when its approval has been obtained on application therefor.

The Stock Clearing Corporation will act for Clearing Members in connection with the paying off of loans from banks, bankers and trust companies and other lenders of money to Clearing Members and the making of new loans. Negotiations for loans will be made on the floor of the Exchange or directly between the lenders and borrowers as at present. Forms of return loan agreements and new loan agreements to be executed by the Clearing Members and the banks, bankers and trust companies or other lenders of money will be provided by the Stock Clearing Corporation. Such agreements must be made out in triplicate and all three agreements must be signed by the Clearing Member and also by an authorized representative of the lender. The lender will retain one of the triplicates and two of the triplicates will be delivered to the Stock Clearing Corporation. Such agreements for return loans and for the making of new loans must be delivered to the Stock Clearing Corporation. If not disapproved by the Stock Clearing Corporation within one hour after being delivered to it (subject to certain provisions as to extensions of time), a return loan agreement or a new loan agreement will become operative and the Stock Clearing Corporation will, for account of the Clearing Member in the case of a return loan agreement, pay off the loan and receive the collateral therefor and, in the case of a new loan agreement, receive the amount of the new loan and the borrower will deliver the securities direct to the lender or the Stock Clearing Corporation may deliver the securities to the lender.

The lenders' representatives will be assigned to booths at the Stock Clearing Corporation where they will arrive about 11:30 A.M. with the collateral for the loans that are to be paid off and with checks for new loans to be made. They will remain at the booths until

2:30 P.M. or until their transactions for the day have been completed.

When a loan is paid off and until a new loan is made and the money therefor received, the Stock Clearing Corporation will have possession of the securities except in so far as they are turned over to the Clearing Member for delivery on security balance orders or for other special purposes under safeguards prescribed by the Stock Clearing Corporation.

The day's transactions between the Stock Clearing Corporation and each Clearing Member will be settled at the close of business by delivery of securities and payment of money due to or from the Clearing Member.

Charges

The charges of the Corporation will be as follows:

First, A charge will be made of five cents for every 100 shares on each side of the sheet including balances in the Night Clearing Branch, as at present.

Second, A charge for services rendered for the values represented by the receipt and delivery of securities will be at the rate of two cents for every $1,000 on each side.

Third, A charge of one cent for each $1,000 involved in clearing a bank loan. (In this connection, the paying off of a loan through the Stock Clearing Corporation of $100,000 will cost the member $1.00 with an equal charge of $1.00 for making a new loan in the same way for the same amount.)

The above-mentioned scale of charges will be subject to revision based upon the expenses of the Stock Clearing Corporation.

APPENDIX D

NEW YORK COTTON EXCHANGE CLEARING ASSOCIATION RULES

The rules and regulations prescribed by the New York Cotton Exchange for the operation of the clearing house department are as follows:

Method of Clearance

The Association may accept contracts offered to it by Clearing Members for clearance, and by such acceptance shall, in place of either party to a contract so accepted and toward the other party thereto, assume the obligations imposed thereby and succeed to and become vested with all the rights and benefits accruing therefrom, assuming to the buyer the position of seller and to the seller the position of buyer, as the case may be. As between the Association and each of the parties to an accepted contract, the terms and conditions thereof shall continue in full force and effect.

Each Clearing Member shall make daily reports to the Association of all contracts for future delivery of cotton made by such member on the New York Cotton Exchange with other Clearing Members in accordance with rules and regulations prescribed by the Directors.

Each report shall be accompanied by a check to the order of the Association, or draft upon it, for the amount necessary, after allowing for amounts theretofore paid on account, to mark outstanding contracts with the Association, together with all other contracts set forth in the 1eport, to the last closing bid prices on the New York Cotton Exchange for cotton deliverable in the months mentioned in such contracts, respectively. (Marking a contract to the closing bid prices is the payment of receipt of the difference between the value of the contract at the contract price and at the closing bid price.) There shall also be attached to and be delivered with such report a check for any original margin that may be required, as prescribed in the subsequent text.

All contracts reported to the Association as above provided shall be deemed accepted by it, unless the parties thereto are notified in

writing to the contrary by the Association on or before 11 A.M. on the business day following that on which the contracts are made, up to which time the Association has the right to refuse to accept any contract reported to it as aforesaid.

Transferable Notices

Notices of delivery may be issued and passed to the Association in accordance with such regulations as the Directors may adopt. Original margins on trades on which notices have passed shall not be released until the delivery is complete, unless otherwise ordered by the Directors.

Guaranty Fund

Each Clearing Member as defined heretofore shall, before the Association becomes a party to a contract with him, advance to the Association the sum of fifteen thousand dollars ($15,000), and the monies thus advanced shall collectively constitute a fund to be known as the "Guaranty Fund of the New York Cotton Exchange Clearing Association, Inc." The monies thus advanced shall be deposited by the Association in a Special Account in its name in such depositories in the City of New York as may be selected by the Directors, and may from time to time be used for the payment of any loss or damage to the Association caused by default of any Clearing Member.

The Guaranty Fund or any part thereof which may be lost through the insolvency of any depository or through embezzlement or defalcation, shall be forthwith restored by transferring thereto all of the surplus that may be necessary, except such an amount, not exceeding $1,000, as the Directors may decide to retain in the surplus fund, and if the amount thus transferred from the surplus fund be not sufficient to cover the entire loss, the balance thereof shall be assessed in equal shares upon the Clearing Members of the Association, who shall immediately (but in no case to exceed one business day) after notice in writing of such assessment shall have been delivered at the offices of such Clearing Members, pay the same to the Association.

After a Clearing Member ceases to be a member of the Association by death, resignation or otherwise, and after his actual and contingent obligations to the Association shall have been discharged in full, so much of his original contribution to the Guaranty Fund as shall remain to his credit therein, after it has been applied, as provided in these By-Laws, to the purposes for which it was contributed, shall

be returned with interest thereon to such member or his legal representatives or assigns. Monies advanced by members to the Guaranty Fund, as provided in this section, shall bear interest at the rate of 3 per cent per annum.

Original Margins

An original margin shall be deposited by each Clearing Member upon his net interest in his contracts with the Association, and shall be for an amount not less than is prescribed in the following schedule, viz.:

(a) Upon a net interest of 50,000 bales or less, $3 per bale.
(b) Upon a net interest in excess of 50,000 bales, but not over 100,000 bales, $4 per bale upon such excess.
(c) Upon a net interest in excess of 100,000 bales, $5 per bale upon such excess.

The Directors may at any time upon 24 hours' previous notice in writing, to be delivered at the offices of all Clearing Members, require that an original margin of $5 per bale be maintained upon the entire net interest of members in their contracts with the Association. This requirement shall remain in effect until withdrawn by the Directors.

In addition to the margin required above on the net interest of each Clearing Member upon contracts with the Association, an original margin of 50 cents per bale on each month shall be required on all straddles between months.

The Directors may at any time upon 24 hours' previous notice in writing, to be delivered at the offices of all Clearing Members, increase the original margin required on straddles.

Whenever the closing bid price of any month or months is in excess of the closing bid price of any succeeding month or months, the buyer of such premium month or months shall, upon 24 hours' notice in writing, deposit such additional margin as the Directors may require.

No Clearing Member shall be allowed to have contracts with the Association representing a net interest of more than 400,000 bales, or a straddle interest of over 400,000 bales, nor in any event shall all of his contracts with the Association maturing in any one month amount to more than 500,000 bales.

Original margins shall be deposited in any Bank or Trust Com-

pany approved by the Directors. Checks for such margins shall be made payable to such approved depository as a member may select. and shall be attached to and be delivered with the daily reports made by members under these rules, and such funds shall be at the risk of the member depositing. The Association shall deliver such checks to the depositories to whose order they are drawn and procure certificates of deposit therefor, which shall state that they are payable to the order of the member depositing or the Association as the Superintendent of the New York Cotton Exchange shall direct, and shall hold such certificates until the margin is released under the rules of the Association. Receipts for margins deposited as above shall be given by the Association to the member depositing. Margins which are no longer required shall be released by the Association and the certificates duly indorsed shall be delivered to the member entitled thereto upon the return receipt.

Under such regulations as may be established by the Directors, receipts of an approved Bank or Trust Company for United States Bonds may be deposited, in lieu of cash, in fulfillment of Members' original margin requirements.

Variation Margins

Acting under such general rules as the Directors may promulgate, the Treasurer of the Association shall call for margins to meet the variations in the market at any time during the day. Such margins must be paid to the Association in accordance with rules to be prescribed by the Directors.

Defaults

A Clearing Member shall be deemed to be in default:

1. When he fails to meet any of his obligations upon his contracts with the Association.
2. When he fails to pay any assessment levied upon him as provided in these By-Laws.
3. When he fails, omits or refuses to furnish margin when required, pursuant to the By-Laws, Rules and Regulations of the Association.
4. When he refuses, or, without sufficient excuse, omits to make a daily report to the Association of his contracts with other members of the Association, as required by said By-Laws, Rules and Regulations. . . .

5. When his failure or suspension has been announced from the rostrum of the New York Cotton Exchange.
6. When his death has been announced from the rostrum of the New York Cotton Exchange, and he has been the sole seller or buyer or the only Member of the New York Cotton Exchange in his firm.

Upon such default being made, the Association shall, without unnecessary delay and within three business hours, cause all contracts then outstanding between the defaulting member and the Association to be closed on the floor of the New York Cotton Exchange through a member thereof.

Payment of Losses

If such defaulting Clearing Member shall be unable to pay immediately any deficit owing by him to the Association arising from the closing of his contracts with it in the foregoing manner, the amount of such deficit shall, until collected from such member, be made good by the application of such portion of the surplus of the Association as the Directors determine to be available for the purpose and thereafter by applying thereto the Guaranty Fund, or such portion thereof as may be necessary for that purpose. The amount withdrawn from the Guaranty Fund to make such application shall be promptly restored thereto by assessments levied upon all Clearing Members in the proportion that the number of contracts accepted for clearance from each of them by the Association during the period of the preceding 9 months, bears to the total number of contracts accepted for clearance from all the members during that period.

Clearance Fees

A clearance fee of 10 cents for each contract reported by Clearing Members to the Association shall be paid by them. The amount of this fee may be changed by the Directors in their discretion.

Whenever an assessment shall be made upon members to restore to the Guaranty Fund a loss, as provided above, or to make good the default of a member, the Directors shall charge an additional fee for contracts thereafter cleared, and shall keep the additional amounts thus collected in special accounts. To these accounts, respectively, shall also be credited payments made in reduction of the loss from any of the causes mentioned in the previous text and payments made by a member on account of his indebtedness. The amounts standing to

the credit of such special accounts shall, at such time as the Directors may determine, be distributed to the members assessed in respect of such losses or defaults. Such additional fee shall be discontinued as soon as all assessments shall have been repaid.

Specific Rules

1. Calls for margin to meet variations in the market shall be delivered in writing at the offices of members and the time of delivery shall be noted thereon by the messenger delivering and clerk receiving same. The amount due must be paid by certified check to the Association within one hour after delivery of the call provided that all calls made before 2:30 shall be met before three o'clock.

Variation margins paid to the Association during the day may be withdrawn if no longer needed, by the presentation to and acceptance by the Association of the draft for the amount claimed.

2. No contracts shall be entered by members on their daily reports to the Association unless contracts or slips have been previously signed by both parties in accordance with the By-Laws of the New York Cotton Exchange.

3. Any member who issues or passes to the Association a notice of delivery as provided in the By-Laws and Rules of the New York Cotton Exchange shall further pass such notice of delivery to the member whom the Association may name.

Any member who passes to the Association a notice of delivery where there is not sufficient time for him before 3 P.M. (3:30 P.M. on the last Notice Day) to pass such notice to the member named by the Association, shall himself be deemed the last acceptor unless the party to whom he tenders the notice accepts it voluntarily.

Notice issued to the Association must be delivered before nine A.M.

4. Any Bank or Trust Company designated by the Board of Managers of the New York Cotton Exchange as a depository for margins is approved as a depository for margins of this Association.

5. Members issuing and/or stopping transferable notices shall make note of same on their Clearance Sheets, and shall maintain original margin on such contracts until the cotton has been delivered. Variation margin on such contracts shall be deposited in trust when called.

When original margin requirements are increased by the receipt or delivery of cotton, proper adjustment of original margin shall be made on the sheet of the day previous to delivery.

If trading in the current month has ceased before the day fixed for delivery, the Association may call variation margin based on the variation in price of the next month's delivery.

Members who shall deliver notices to non-members, or who shall receive notices from non-members, shall immediately notify the Association, and shall adjust their market position with the Association (if any adjustment is required) under its directions.

6. When a member is called for variation margin, prior to the delivery by the Association of draft against his credit balance of the previous day, the Association will, upon request in writing, credit him with the amount of such draft, against said call for variation margin.

7. On the last day upon which trading is permitted in cotton for delivery during any month, all transactions made in the current month shall be reported immediately to the Clearing Association, stating name of firm with whom the transaction is made.

8. All original margins shall be deposited in multiples of not less than Five Hundred Dollars ($500.00).

9. Certificates of Deposit (issued by any Bank or Trust Company designated by the Board of Managers of the New York Cotton Exchange as a Depository for Margins) for United States Coupon Bonds, will be accepted as original margin at 90% of the face value of such bonds. Such certificates shall be in form approved by the Directors and shall require the delivery of the said bonds to the member depositing, or to the New York Cotton Exchange Clearing Association, Inc., as the Superindendent of the New York Cotton Exchange shall direct.

APPENDIX E

CLEARING HOUSE REGULATIONS OF THE CHICAGO BOARD OF TRADE

The following is Rule XX of the rules and by-laws of the Chicago Board of Trade, governing deposits to secure the fulfilment of time contracts:

Sec. 1. On time contracts, purchasers shall have the right to require of sellers, as security, a deposit of ten (10) per cent, based upon the contract price of the property bought, and further security, from time to time, to the extent of any advance in the market value above said price. Sellers shall have the right to require as security from buyers a deposit of ten (10) per cent on the contract price of the property sold, and, in addition, any difference that may exist or occur between the estimated legitimate value of any such property and the price of sale. All securities shall be deposited, either with the Treasurer of the Association or with some bank duly authorized by the Board of Directors to receive such deposits; and shall, in each instance, be accompanied by the following form of memorandum or statement.

<table>
<tr>
<td>
.................................Bank

CHICAGO

.................................19 ...

Margin Certificates Wanted

By.................................
</td>
<td>
.................................Bank

CHICAGO

.................................19 ...

JOHN R. MAUFF,
Sec'y Board of Trade of the City of Chicago

....
have deposited approved Check for Margin Certificate which we will issue today in accordance with your Rules as follows:
</td>
</tr>
</table>

For Depositor and	Amount		
....	....	....	....
....	....	....	....
....	....	....	....
....	....	....	....
....	....	....	....

The above form of memorandum shall state the name of the depository, the date on which the deposit is made, the name of the depositor, and also the name or names of the party or parties in whose favor the deposit is to be made, together with the amount or amounts of such deposit in detail, and also in the aggregate. The left-hand part of the memorandum or statement before described shall be retained by the depository selected, and the right-hand portion thereof taken by the depositor, after being duly signed by the person authorized to receipt for the said deposit, and, without delay, placed in the office of the Clearing House of the Board of Trade of the City of Chicago; it being distinctly understood that the provisions of Section 2 of this Rule are and shall remain in force, and that the issuance of the certificate in the form and manner prescribed in said Section 2 is unaffected by the provisions of this section. It is hereby provided that such deposits shall not be made with any bank or banks to which the party calling for the said security shall expressly object at the time of making such "call"; but in such case the deposit shall be made with some duly authorized bank not thus objected to, or with the Treasurer of the Association, as the depositor shall elect.

Sec. 2. All banks which may be appointed to act as depositories for securities, shall be required to have one or more of their executive officers, members of this Board, who shall be held amenable to the Rules of said Board in matters of dispute arising from any transactions on the Board of Trade of the City of Chicago, between the banks they represent and any of the members of said Board of Trade, and shall execute and file with the Secretary of the Association a good and sufficient bond, with sureties, to be approved by the Board of Directors, for the proper disposal of the said deposits, in accordance with the provisions of the Rules, Regulations and By-Laws of the Association. Said banks shall issue certificates in duplicate, not transferable, for all such deposits. Said certificates shall state by whom the deposit was made, and for whose security the same is held, that the deposit has been made under the Rules of the Board of Trade and is payable upon the return of the certificate or its duplicate, duly indorsed by the parties to the contract or contracts, or on the order of the President of the Board of Trade, as provided by Section 6 of this Rule. Said certificate shall be in the following form, to wit:

ORIGINAL (or) DUPLICATE

Not Negotiable or Transferable

Chicago......................19.....

....has deposited with this Bank ....Dollars as security on a contract or contracts between the depositor and.................................... which amount is payable on the return of this certificate or its duplicate, duly indorsed by both of the above-named parties, or on the order of the President of the Board of Trade of the City of Chicago, indorsed on either the original or duplicate hereof, as provided by the Rules of said Board of Trade, under which the above-named deposit has been made.

....

Cashier.

All deposits so made shall be held to have been made as security for the faithful fulfillment of any contracts made or to be made between the parties during the time the deposit shall remain unpaid; *provided,* it shall be competent for either party to a contract to demand that the certificate shall express the particular contract upon which the deposit shall have been made, and in such case the deposit shall be applicable only to the settlement of that contract.

Sec. 3. The Treasurer of the Association shall, in like manner and under like safeguards, receive deposits for security, and issue certificates for the same, payable as is provided by Section 2 of this Rule.

Sec. 4. The party depositing security shall, within one hour from the time such deposit shall be called, deposit with the Clearing House of the Board of Trade of the City of Chicago, or with the party calling for such deposit, the duplicate certificate for the same, in due form, as provided for in Section 2 of this Rule.

Sec. 5. Should any party called upon, as herein provided for, fail to deposit the security called within the next banking hour thereafter, the party making such call shall have the right, if he be the seller, to resell the property for account of the delinquent, such resale to be for the same delivery as was named in the original contract; if he be the buyer he shall have the right to repurchase the property for account of the delinquent, deliverable at the time named in the original purchase; in either case he shall at once communicate to the delinquent the action he has elected to take, and all losses or damages on such defaulted contract shall be at once due and shall be payable through the Clearing House the same as though said con-

tract had fully matured. The party so calling may, however, elect to permit the contract to stand, in which case no notice to that effect shall be necessary to the delinquent. All notices for the call of deposits as security, or of the closing of contracts under this Rule, may be served on the party called, either in person or by leaving a written notice at his place of business, or may be served in person upon his authorized representative, or upon any clerk representing the party on 'Change; and in case the party called upon shall not be known to have a regular place of business, a written notice left in the office of the Secretary of the Board shall be deemed sufficient.

Sec. 6. Upon the fulfillment or settlement of any contract, or upon the closing of any contract under the provisions of Section 5 of this Rule, deposits upon which have been made, and when the full adjustment of all differences relating to the same shall have been effected, the deposits shall thereupon be payable to the party depositing the same; and the joint indorsement of both parties upon the certificate shall be a sufficient authority to the party holding the deposit to pay the same to the holder of the certificate; or in case of a failure between the contracting parties to adjust and settle their respective claims upon the deposit within three (3) business days after the maturity of all contracts upon which the deposit is applicable, the matter in dispute shall, upon the application of either party to such contracts, be submitted to a select committee of three disinterested persons, members of the Association, to be appointed by the President, which committee shall, without unnecessary delay, summon the parties before them, and hear such evidence under oath as either may wish to submit touching their claims to the deposit, and shall by a majority vote decide, and report to the President of the Board, in writing, in what manner and to whom the deposit is payable, either wholly or in part, whereupon the President shall indorse on either the original or duplicate certificate an order for the payment of such deposits in accordance with the decision of said committee, and such order shall be a sufficient warrant to the party holding the deposit to pay the same in accordance with such order. In case any member neglects or refuses to indorse a certificate of deposit to the party entitled to receive the money thereupon when all contracts upon which the deposit is applicable are settled, and all money due upon such contracts has been paid, he shall be liable to a penalty of one per cent per day on the amount of such certificates, for every day such refusal or neglect is continued; and for refusal to promptly

pay such penalty, the party may, upon due complaint, be suspended from all privileges of the Board until the same is paid. In case it should occur that by reason of changes in the market, or of delivery upon, or the settlement of a portion of the contracts upon which security has been deposited and to which such security is properly applicable under this Rule, that a larger sum remains on deposit than is contemplated by Section 1 of this Rule upon then existing unadjusted contracts between the parties, and either party to such contract should refuse to release such excess of deposit, the President of the Board is authorized, upon a representation of the facts and admission or proof that such excess ought to be released, to order such release and payment to be made to the party to whom it rightfully belongs, by the indorsement of an order to that effect on either the original or duplicate certificate or certificates issued for such deposits; *provided,* in case of such disagreement no surrender of the deposit shall be ordered pending any arbitration touching the rights of the parties under the said contract or contracts, or in case the party refusing to adjust the dispute shall signify his willingness to submit the matter to arbitration.

Sec. 7. In determining the value of property under this Rule, its value in other markets, or for manufacturing or consumptive purposes in this market, together with such other facts as may justly enter in the determination of its value, shall be considered irrespective of any fictitious price it may at the time be selling for in this market. Such value, for the purposes of this Rule, in case of disagreement, shall be determined by the Board of Directors, and communicated to the parties in interest through the President or Secretary.

Sec. 8. On to-arrive grain contracts of thirty days or more, buyers shall have the right to require of non-resident sellers as security to be deposited with the buyer, a deposit of ten per cent, based upon the contract price of the property bought, and further security, from time to time, to the extent of any advance in the market value above said price.

Deposits so made shall be released on the performance of the contract or before, in the discretion of the buyer, or may be held in whole or in part in conformity with the requirements of this section, applicable to any other contracts between the principals.

Failure to deposit security, as required by this section, within two business days, shall entitle the buyer to elect to declare any or all contracts covered by such call, canceled, or to re-buy on the open

market an equal quantity of the commodity covered by the contract, and the buyer shall at once notify the seller of such action.

Disputes arising from security calls, deposits or release of them may be referred to the To-Arrive Grain Committee and its decision shall be binding on both principals.

Below is given, in part, Rule XXII of the rules and by-laws of the Chicago Board of Trade, which prescribes the rights of parties on contracts:

Sec. 6. In case it shall appear that the delivery of any outstanding trade or contract between members of the Association may be offset by some other corresponding trade or contract, made by the parties with other members of the Association, and the parties to such trade or contract, or their authorized agents, consent to such offset, such trade or contract shall be deemed to have been settled, and any balance between the current market value of the property covered by such trade or contract, and the several contract prices shall be due and payable immediately by the party from whom such balance may be due to the party entitled to receive the same under his contract. The current market value of the property contracted for shall be conspicuously posted, at a stated hour each day, under the direction of the Board of Directors, in the Exchange Hall and in the settlement room of the Board, which posting shall serve as a basis for the adjustment of all contracts settled, as herein provided on that day.

In order to facilitate the operation of this section, each member is required to keep a settlement book in which shall be entered the names of parties with whom settlements have been made, and the dates and terms of the trades included in such settlements, and the terms of such settlements, and the prices at which the commodities were originally sold or purchased, and the amounts due to or from him or them on each separate settlement, also the net amount due to or from him or them on all settlements; and the Board of Directors is hereby authorized to provide a suitable office, with the necessary employes, to which members shall be required, at stated hours each day, to make reports, showing the net balance due to or from each member, as shown by such settlement book, and also the general balance due to or from him or them upon all such settlements; each report to be accompanied with an acceptable check for the aggregate of balances,

if any, due from him or them on the contracts so settled; whereupon, if said report is found to be correct, as compared with other reports rendered him, the person in charge of said office shall, at a stated hour each day, pay to each of the parties making such reports any balances which he may have collected, and which shall appear to be due to them by said reports, less such charges as shall be prescribed by the Board of Directors as compensation for the services of said office.

Sec. 7. It shall be the duty of each member or firm making a transaction for future delivery of grain or flaxseed in 5,000 or 10,000 bushel lots, pork in 250 package lots, lard and D. S. short ribs and D. S. extra short clears in lots of 50,000 pounds, under the rules of the Association, to confirm such transaction by sending to the Clearing House a memorandum of the same by 6:00 o'clock P.M. of the day on which it is made; such memorandum shall be in writing, and shall state on its face the date of the transaction, the quantity and kind of property covered by the same, the month of delivery, the price, and the name of the party to whom sold or of whom bought, and shall be signed by the party or firm making the same. All transactions of the same date made with any member or firm may be included in one memorandum, and all such memoranda shall be sent to the Clearing House by the member or firm making the same, in unsealed envelopes addressed to the member or firm with whom such transactions were made: *provided,* that if any member, firm or corporation is unable, with diligent effort, to check any transaction made with another member, firm or corporation, in the manner herein provided, such transaction shall be closed out for the account of whom it may concern by the member, firm or corporation claiming the contract, before the close of trading hours of the next business day, in order to establish any claim for loss because of such failure to check by the other party to the contract. It shall be the duty of the Clearing House Manager to assort and have ready for delivery by 8:00 o'clock A.M. of the following day, and to deliver, on application, all envelopes containing such memoranda as are left with him in compliance with this section. In order to enforce this section, it is hereby provided that any member or firm failing to comply with its provisions, shall be fined $5.00 for each offense, and for repeated offenses they may be disciplined by the Directors under the provisions of Section 9 of Rule IV.

Sec. 8. It shall be the duty of each member or firm making an offset of any outstanding contract for future delivery, to confirm the

same by sending to the Clearing House a memorandum of the same by 6:00 o'clock P.M. of the day on which it is made; such memorandum shall be in writing, and shall state on its face the date of the offset and the amount proposed to be paid or collected. When several offsets have been made on any one day, the memorandum shall state the net amount only of the proposed payments or collections; such memoranda shall be sent to the Clearing House by the member or firm making the same, in unsealed envelopes addressed to the member or firm with whom such transactions were made. It shall be the duty of the Clearing House Manager to assort and have ready for delivery by 8:00 o'clock A.M. of the following day, and to deliver on application, all envelopes containing such memoranda as are left with him in compliance with this section. In order to enforce this section it is hereby provided that any member or firm failing to comply with its provisions shall be fined $5.00 for each offense, and for repeated offenses they may be disciplined by the Directors under the provisions of Section 9, of Rule IV.

Sec. 9. In case any member of this Association, acting as a commission merchant, shall have made a purchase or sale by order and for account of another, whether the party for whom any such purchase or sale was made be a member of this Association or not, said member shall be deemed authorized to settle such contract through the Exchange Clearing House of this Association, and under the Rules and Regulations relating to such Clearing House; and the Board of Directors of this Association are authorized to establish Rules and Regulations governing the Exchange Clearing House of this Association, and to change, add to, or modify such Rules and Regulations from time to time. In case any member of this Association, acting as a commission merchant, shall have made purchases or sales by order and for account of another, whether the party for whom such purchase or sale was made be a member of this Association or not, such order shall be deemed to have been made with reference to, and to be executed and carried out in all respects under the Rules, Regulations and Customs of this Association (including the Exchange Clearing House Regulations) the same as though they were in terms incorporated into such order; *provided,* that in case of substitution of one contract for another, or of offsets or settlements of contracts in pursuance of such Rules, Regulations or Customs, the member or firm making the same shall be held to guarantee to his or their principal the ultimate fulfillment of the original contract made under such

order, and the principal also continuing liable on such original contract, the same as though no substitution, offset or settlement were made.

Following are the regulations adopted by the Chicago Board of Trade to govern the operation of its Clearing House:

I. The style and address of each member of the Clearing House of the Board of Trade of the City of Chicago—in the case of a corporation, the names of its officers and directors and its corporate name; in the case of a firm, the names of its members and its firm name—must be immediately registered at said Clearing House; also must be immediately registered any change in the style or address of any member of the Clearing House—in the case of a corporation, any change in its corporate name or in its officers or directors, and in the case of a firm any change in the firm name or in the membership thereof.

A fine of five dollars ($5.00) shall be imposed in case of violation of any of the above requirements.

Suitable blanks shall be provided by the Clearing House for furnishing the information as hereinbefore set forth and required.

A copy of all registrations, as above set forth, shall be sent by the manager of the Clearing House to each and every member thereof; also, a copy shall be filed by the Clearing House with the Secretary of the Board.

II. Printed reports to show the net balances, as provided in General Rule No. XXII, Section 6, Paragraph 2, must be obtained at the Clearing House.

III. Any person, firm or corporation, member of the Clearing House of the Board of Trade of the City of Chicago, whose report shows a balance against such person, firm or corporation, shall accompany his or its report with a check payable to the order of the Clearing House of the Board of Trade of the City of Chicago for such balance; such check, if not issued by the said Clearing House of the Board of Trade of the City of Chicago, if in excess of $100, must be duly certified, under penalty of a fine of five dollars ($5.00). Should payment on a certified check be stopped the maker must immediately upon receiving official notice thereof, deposit with the said Clearing House of the Board of Trade of the City of Chicago another and acceptable check.

IV. All reports must be in the Clearing House by 11:20 A.M. of each business day, under penalty of a fine of five dollars if tardy, and the posting of the delinquent party on 'Change at 12:00 M., except on days when the Exchange Room is closed a 12:00 o'clock M., when the names of delinquents shall be posted at 11:45 A.M. All reports deposited in the Clearing House after 11:25 A.M. shall be subject to an additional fine of one dollar for each five minutes or part thereof between 11:25 A.M. and the time at which they are deposited at the Clearing House.

V. Parties having no items to clear must so report in writing, *under penalty of a fine of one dollar for neglect of such report;* and parties whose reports may be equal on both sides, and those whose reports show a credit balance, must put them in the Clearing House, under penalty, as provided in Art. IV above.

N. B.—To insure accuracy and expedite the clearings, parties must be sure the amounts claimed are mutually agreed upon and correct. A penalty of one dollar will be collected of any party claiming from or allowing to another party a wrong amount, and also for each error in footing or subtraction. All doubtful items must be excluded from the report.

VI. If a claim is not allowed by the debtor, the claimant must on notice thereof, pay to the Clearing House by certified check the amount claimed; such payment to be made before 1:00 o'clock P.M. of the day on which notice is served, under penalty of a fine of five dollars ($5.00). If such claim is not paid prior to 2:30 o'clock P.M. of the same day, the Clearing House will hold whatever funds it may have belonging to the claimant or his creditors, until such claim is satisfied.

VII. In case a party, in his report, allows another party an amount in excess of that claimed by the second party, the excess will be refunded to the first party.

VIII. The charge for clearing, as provided by the Rules, has been fixed at one and one-half cents for each item in each report, the same to be paid monthly on presentation of the bill by the Clearing House. Fines to be paid at time of notification that the same have been incurred, under penalty of the withholding of the next amount due such debtor or reporting the delinquency to the Board of Directors.

IX. Parties whose reports show a net balance in their favor may call for check after 2:30 P.M.

X. No reports shall be amended after 11:20 A.M.

XI. Office hours shall be from 9:00 A.M. to 3:30 P.M.

XII. No firm shall be allowed the privileges of the Clearing House while any member of said firm is under sentence of suspension by the Board of Directors.

XIII. No corporation shall be allowed the privileges of the Clearing House while any officer of said corporation is under sentence of suspension by the Board of Directors. And whenever one of the executive officers of any corporation enjoying the privileges of the Clearing House shall have been expelled or suspended for misconduct in connection with the business of said corporation, such corporation shall thereafter and during the period of such suspension be entitled to the privileges of the Clearing House only after favorable action of the Board of Directors upon its written application for such privileges.

XIV. Any corporation applying for membership in the Clearing House of the Board of Trade of the City of Chicago, may be admitted to such membership only upon recommendation of the Clearing House Committee, in the exercise of its discretion, and upon approval by at least ten affirmative ballot votes of the Board of Directors; *provided,* that three negative ballot votes are not cast against any such corporation.

XV. When any member of the Clearing House, whether person, firm or corporation, is, in the opinion of the Clearing House Committee, using such Clearing House for the purpose of clearing the business of a member suspended from the privileges of the Board or one expelled therefrom, or of a corporation a stockholder of which is suspended from the privileges of the Board or expelled therefrom, the Clearing House Committee shall report such fact to the Board of Directors, who, in the exercise of its discretion, may deprive such a person, firm or corporation of the privileges of the Clearing House for such period as they may see fit; the intent hereof being to prevent any membership in the Clearing House being used as a subterfuge to enable one suspended or expelled from the Board to still enjoy the advantages of the Clearing House, but not to prevent a member from clearing the individual trades made for the account and personal benefit of one suspended or expelled from the Board.

XVI. Applications by persons or firms for membership in the Clearing House of the Board of Trade of the City of Chicago must be submitted to the Clearing House Committee and passed upon

favorably by them before applicants will be entitled to the privileges of the said Clearing House of the Board of Trade of the City of Chicago.

XVII. When any member of the Clearing House of the Board of Trade of the City of Chicago, whether person, firm or corporation, has not for the period of one month cleared any trades through the said Clearing House, such person, firm or corporation shall cease to be a member of the said Clearing House; and no such person, firm or corporation can resume his or its membership in the said Clearing House, except by making a new application for membership therein and in accordance with all the provisions of Section 30 of Rule IV of the Rules of the Board of Trade of the City of Chicago and Regulations XIV and XVI of the Regulations of the Clearing House of the said Board of Trade of the City of Chicago.

APPENDIX F

GENERAL INSTRUCTIONS FOR INTERNAL REVENUE FORM 747

The following general instructions are printed on the reverse side of Form 747 which all dealers in future contracts in commodities must file with an internal revenue officer:

1. *Persons Required to Make Return.* Every person who makes contracts of sale or purchase of any product, or merchandise, at *or under the rules and usages* of any exchange, board of trade, or other similar place of business, for future delivery, whether such contracts shall be cleared and adjusted through a clearing house, or directly between seller and buyer, or otherwise, must make a return of all such transactions, written legibly in ink, to the Commissioner or duly designated officer. If during the month no transactions have been made by the person required to file return, a statement to that effect must be filed in lieu of a return. Returns written with pencil will not be accepted.

2. *Date of Filing Return.* The return must be filed on or before the fifteenth day of each month for the transactions of the preceding month, or for any other period required by the Commissioner. A return mailed on the fifteenth day of the month will be accepted as if delivered on that date.

3. *Signature and Verification.* Returns must be signed and verified either by the person making such return or by his duly authorized agent, and must be sworn to before an officer authorized to administer oaths, and the seal of the attesting officer, if he is required to have a seal, must be inpressed on the return. The oath will be administered without cost by any collector or deputy collector of internal revenue or by any internal revenue agent charged with the handling of such return.

4. *Returns to be Checked.* All figures on the return should be carefully checked against the facts as disclosed by the books of record.

5. *Statement of "Future Delivery" Stamps Bought and Used, and*

Consolidated Stamp Statement. All "future delivery" stamps purchased and used during the month, as well as stamps on hand brought forward from the preceding month and the stamps remaining on hand at the close of business for the month reported, must be accounted for each month in the blanks provided for that purpose.

In markets where two or more commodities are dealt in, convenience in preparing the consolidated stamp statement of the amount of "future delivery" stamps bought and used and uniformity of practice throughout will be obtained by summarizing, on one predetermined return, all stamps used on the contracts of the various other commodities. For example: Summarize "Wheat," "Corn," "Oats," "Lard," etc., upon the "Wheat" return, and continue that practice in like manner each month; and across the face of the "SUMMARY" blank on each separate return write that the "Total tax paid" on such return is forwarded to the *consolidated stamp statement,* viz.: "See Wheat."

Special Instructions

6. *Separate Returns Required.* (a) Separate returns must be filed each month for each class of business conducted, one return for the twelve months of delivery, segregating the several months of delivery under the proper columns on each return.

(b) "Privileges," "Offers," "Puts and calls," etc. Separate returns must be filed for that class of business variously known as "privileges," "deferred acceptance contracts," "offers," "puts and calls," etc. (See paragraph 19, below.)

(c) Contracts made under the rules or usages of any exchange. If the transactions were not made at or on an exchange, but were made "under the rules or usages of any exchange . . . for future delivery" (meaning a sale not expressly requiring immediate or prompt delivery within twenty days), a separate return must be filed for each class of business so conducted.

7. *Method of Entering Quantity.* The unit of measure for the product must always be stated in the blank provided for the purpose, for example:

250 tierces lard, 340 pounds each, or 85,000 pounds.
1,000 bushels corn.
5,000 bushels wheat.
50 bags clover seed, 2½ bushels each, or 125 bushels.
100 bales cotton, 500 pounds each, or 50,000 pounds

For the sake of convenience and brevity in case of contracts made in multiples of thousands, enter the figures therefor and omit the last three ciphers; in case of contracts made in multiples of hundreds, omit the last two ciphers; but in case of contracts made in odd numbers or multiples thereof, each contract must be treated as a numeral and entered as 1. Illustrations:

1,000 bushels oats, enter the figure 1.
115,000 bushels wheat, enter the figures 115.
1,000 bales cotton, enter the figure 10.
250 barrels pork, enter the figure 1.
50 bags clover seed, enter the figure 1.

The above will illustrate a ready method of reporting other contracts not mentioned.

8. *Open Contracts, Brought Forward, or Carried Forward.* This return is in the form of a balance sheet, therefore the open contracts brought forward from the preceding month or carried forward to the succeeding month, as the case may be, must agree with the position with relation to the exchange, or "on 'change," or "the street." The number of open contracts at the end of the month may be verified by deducting from the "grand total" of purchases and sales (including "open contracts brought forward") the number of "spots" received or delivered. The remainder is the position "on the street" or "on 'change." Unless specifically required by the Commissioner, the open contracts with relation to customers' position must not be reported. Unsigned contracts must be included in the transactions of the next business day.

9. *Settlements.* For the purposes of the regulations and the form of return, a "settlement" is either the actual delivery or receipt of the product, or, in case of a purchase and sale, or "round turn," the matching of such purchase against such sale, resulting in an "offset" or "set-off" either directly between the buyer and seller, or through a clearing house, or otherwise, as variously known in the different localities and enumerated on the face of the return. Therefore, except in cases of actual delivery or receipt of the product, settlements against purchases must balance settlements against sales, for a settlement is the matching of a purchase against a sale.

10. *Deliveries.* When a contract is fulfilled by the actual receipt or delivery of the product, or "spot" or "cash," such a settlement must be

reported in the space "Deliveries," against contracts "Bought" or "Sold," as the case may be.

11. *Transferable Notices, or Contracts Settled by "Notice."* Except in cases of settlements by "Notices issued" or "Notices stopped" (which are to be treated as deliveries and so reported in the space "Deliveries"), all settlements of contracts by "Transferable notices passed," or by "Notice," are to be reported in the space "Transferable notices passed," the figures under both "Bought" and "Sold" columns to be indentical, as is likewise the rule in all other "offset" settlements. In cases of transferable notices resulting in "offset" settlements in the clearing house, such "offset" settlements are to be reported as "Transferable notices passed," and the number of offset settlements by the clearing house is therefore to be accordingly reduced.

12. *Other "Offset" Settlements.* All other "offset" settlements are to be reported in the spaces provided for that purpose, viz.:

13. *Settlements Through Clearing House.* Contracts settled through a clearing house or clearing association by "offset," as above described, are to be reported in the space "Clearing house or association." Exceptions: "Notices issued," "Notices stopped," or "Spots," or "Cash," or "Transferable notices passed," or "Notice." (See paragraphs 10 and 11, above.)

14. *Direct Settlements, "Offsets," etc.* If a person, A, makes a sale to another person, B, and thereafter purchases a like quantity of the same product for the same month of delivery from B, or vice versa, and "sets-off" or "offsets" such purchase against such sale—that is, makes a settlement thereof "direct" with B—the purchase and sale are to be entered in the respective columns and the settlement thereof is to be reported in the space "Direct settlements," "Offsets," etc.

15. *Rings.* A "ring" settlement is effected through at least three persons. Thus: A makes a sale to B and then, or thereafter, purchases a like quantity of the same product for the same month of delivery from C. Now if B sells to C it is obvious that the contracts of A, B, and C can be settled by the ringing method—by whatever name or term called—a principle well understood in all exchanges. The principle may be extended indefinitely. A "ring" may result from the usual course of trade or a person may "give a ring." In either event the tax applies equally to the sales in "rings" resulting from the regular transaction of business.

16. *"Pair Off," "Matched," or "Crossed" Trades.* In case a

person is both buyer and seller, or such person "pairs-off" or "matches" or "crosses" the sale of one customer with or against the purchase of another customer, return is to be made of such purchase and sale in the respective columns and the settlement thereof is to be reported in the space "Pair off," etc.

17. *"Pass Outs," "Scratch" or "Transferred" Trades.* (See paragraph (3), Article 33, of Treasury Regulations No. 40, Revised.) Return of such transactions must be made entering by interlining in red ink the purchases and sales in the respective columns, and the settlements therefor are to be reported in red ink in the space "Pass outs," "Scratch," or "Transferred" trades.

18. *"Give Ups," "Brokerages," "Clearances."* If any person, A, whether or not accustomed to clearing his own contracts, makes contracts executed as brokerages or commission business, or as a "clearance" for his own account, or otherwise, and thereafter "gives up" such contracts to another person, B, to clear, carry, or settle, return of such transactions must be made by A, entering by interlining in red ink the purchases and sales in the respective columns, and the settlements therefor are to be reported in red ink in the space "Give ups," against "Brokerages" or "Clearances," as the case may be.

19. *"Privileges," "Deferred Acceptance Contracts," "Offers," "Puts and Calls," etc.* Separate returns are required for this class of business. (See paragraph 6, above.) Return of such transactions must be made, entering the purchases and sales in the respective columns, and the settlements therefor are to be reported in the space "Privileges," etc., against "Option expired," or "Option exercised," as the case may be. When the "option is exercised," or the "offer is made good," the tax having already been paid and accounted for under a separate return, as required, such contracts then automatically become a part of the other future delivery contracts and must be reported as such, entering by interlining in red ink (to indicate the inclusion in the former return of "Privileges" and also to show that the tax has already been paid) the purchases and sales in the respective columns, and the settlements therefor are, of course, to be reported in the ordinary manner, depending upon the method of settlement.

20. *Settlements by Other Methods.* Return is to be made of all purchases and sales in the respective columns, and the settlements thereof, however settled, if made by other methods than those enumerated herein, are to be reported in the space "Other methods," with notations fully explanatory of such settlements.

21. *Summary: Origin of Orders.* The origin of the orders (meaning the address of the person whose account is debited or credited and whether in the United States or foreign country) executed during the current month and to be reported in this space and summarized.

22. *Regulations and Penalties.* For further information regarding these matters, see Treasury Regulations No. 40, Revised, and consult the Internal Revenue Bureau in the district in which the exchange is located.

INDEX

L

M

N

O

P

R

S

FEB 13 1980 REC'D